

THE STATE OF THE SECURITIES INDUSTRY

HEARING

BEFORE THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

ON

THE RECENT INITIATIVES TO ENHANCE INVESTOR PROTECTIONS IN
OUR SECURITIES MARKETS, FOCUSING ON FUND ADVERTISING,
PROXY VOTING, SARBANES-OXLEY ACT REQUIREMENTS, FUTURE MU-
TUAL FUND ACTIVITY, THE HEDGE FUND REPORT, AND THE CANARY
INVESTIGATION

SEPTEMBER 30, 2003

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THE STATE OF THE SECURITIES INDUSTRY

TUESDAY, SEPTEMBER 30, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met, at 10:05 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order. I would like to welcome back to the Committee, Chairman Bill Donaldson of the SEC.

As investors slowly recover from the financial fraud and manipulation that characterized the pre-Sarbanes-Oxley era, they now confront business practices and conflicts of interest through which securities firms seem all too willing to sacrifice investors' interests for the sake of profits.

We have seen a number of instances in which the Wall Street investment game appears rigged against the retail investor. In April, this Committee examined the global settlement concerning the conflicts of interest between investment banks and their research analysts. We learned that in order to attract and retain investment banking clients, bankers pressured analysts to issue exaggerated reports that they knew were false or that omitted crucial negative information.

It appeared that everyone on Wall Street knew that analysts were issuing favorable reports in order to inflate stock prices and generate more banking business. The average retail investor, however, was unschooled in Wall Street's ways and lost out.

Recently, we have learned about a number of trading practices involving hedge funds and mutual funds that, once again, profit Wall Street at the expense of average investors. New York Attorney General Spitzer uncovered agreements by which certain large mutual funds permitted a hedge fund to execute illegal trades in exchange for a large investment in the mutual funds. Simply, the mutual funds gave the hedge fund better prices and more information than was available to the average fund investor. This illegal arrangement is just one of the many troubling issues that has come to light in the mutual fund industry.

Mutual funds have always been perceived as the safe investment option for average investors. Yet with the recent revelations regarding illicit trading techniques and additional criticisms con-

cerning cost disclosure and fund sales practices, many have come to question the perceived fairness of the mutual fund industry.

With respect to the hedge fund industry, this Committee has once already considered the lack of transparency and disclosure surrounding the operation of an industry where billions of dollars flow daily. I understand that the SEC has issued a report on the industry and made several recommendations concerning new regulations intended to protect investors. I look forward to hearing the SEC's conclusions and proposals on this subject.

We have also heard a lot regarding the ability of self-regulatory organizations to adequately protect investors' interests. As a result of the controversy surrounding Dick Grasso's compensation, investors have questioned the New York Stock Exchange's corporate governance standards and its effectiveness as a regulator for its member firms. Many contend that the NYSE's self-regulatory structure, in which the chairman is essentially paid by the industry that he oversees, has turned NYSE into an ineffective regulator. Given the current regulatory structure of our markets, I believe it is critical that investors have confidence that regulators are constantly monitoring the industry and are protecting them against misconduct. I understand that the SEC is reviewing the New York Stock Exchange's governance structure and considering the viability of self-regulatory organizations for the securities markets. I look forward to hearing an update from Chairman Donaldson here this morning.

During my tenure as Chairman of the Banking Committee, I have expressed a great concern for investor protection and the need to reform the culture on Wall Street. Our markets depend on a transparent financial system in which investors receive full and timely disclosure concerning their investments and securities firms look out for investors' best interests. Too often it appears that securities firms circumvent transparency and neglect investors' interests in the pursuit of profit. Too often it seems that Wall Street treats sanctions and settlement costs as a cost of doing business.

I believe that we are at a critical juncture in regulating the securities industry. Congress and the SEC need to reassure investors that our markets are a place where they can safely invest their money. Although we cannot legislate morality or legislate away greed, we can ensure that the SEC relentlessly pursues wrongdoing to promote trust in our markets. The purpose of today's hearing is to consider issues concerning investor protection in our securities markets and to understand how the SEC is addressing them. Mr. Chairman, we look forward to your testimony and to the round of questions that will come.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Chairman Shelby. I am pleased to join with you in welcoming Chairman Donaldson of the SEC back before the Committee.

Chairman Donaldson, there is a Chinese saying that one should live in interesting times, and I thought of that saying and of you when I looked at this morning's *The New York Times*. I am going to hold it up. Now, this is on C4. It really is rather daunting.

“Corporate Conduct in the Courthouse. ‘We are ready for it,’ Ex-Chief of Tyco Says as His Trial Begins.” This is Kozlowski. That is this story.

Then here, “SEC Demands Documents From Former Enron Chief,” and here is a picture of Ken Lay, who refuses to produce records that his lawyer says are covered by the Fifth Amendment right against self-incrimination.

“Charges That Ex-Employee Lied to Hide Medco Fraud.” That is a continuation from page 1.

“Investment Banker’s Trial Begins With Scrutiny of Jurors. The criminal trial of Frank P. Quattrone,” and then it goes on from there.

“Rite Aid Lawyer Falsified Earnings, Prosecutor Says.”

And if that is not enough, over here, “Amex Is Accused Of Breaking Pact,” and I thought to myself, I wonder how that impacted Chairman Donaldson at breakfast when he turned inside and saw that.

In addition—and I am going to ask you about this later—there is a full-page ad in Thursday’s *The Wall Street Journal*: “In the wake of scandals like Enron and WorldCom, investors deserve a true voice in director elections.” And then it goes on and discusses the question of open access for shareholders as the next step.

So, Mr. Chairman, I am pleased you are holding this hearing. It gives us an excellent opportunity to assess the status of efforts on a broad front that promote integrity in our markets and the confidence of our investors. And in many respects, this comes at a very opportune time.

Just in the last several weeks, serious questions have arisen in the equities markets over the corporate governance practices of the New York Stock Exchange—questions involving possible conflicts of interest, apparent lack of transparency, levels of executive compensation, and, of course, they also involve the very important question of self-regulation, the traditional dual role of the NYSE as both a securities market and as a regulator of its members.

We know that Chairman Donaldson met yesterday with John Reed, who temporarily has taken over the leadership of the NYSE. I would be interested in his read on where that is going.

In the mutual funds market, the Attorney General of New York has brought charges against major investment companies that allegedly were given preferential pricing to a hedge fund, contrary to their policies and the law. I understand both the SEC and the Attorney General of New York are continuing an investigation of mutual fund practices.

Many other issues remain with us, the appropriate regulation of hedge funds among them. Increasingly, they are marketed to a widening circle of investors, although they remain in many ways unregulated.

We held a hearing on this earlier in the year, under your leadership.

Chairman SHELBY. Yes, we did.

Senator SARBANES. And, yesterday, the Commission released a staff study on hedge funds addressing questions of registration, valuation, sales to retail investors, and other concerns. They made

a number of important recommendations. We look forward to hearing about them this morning.

There is a whole range of other issues—the credit rating agencies, the suitability requirements, sale of proprietary mutual funds. We need to address I think, again, the adequacy of the Commission's funding and what we may need to do in the Congress about that. So we have a very full agenda here, and I look forward to this hearing.

I want at the outset to commend the Commission, the Commission staff, and Chairman Donaldson for their dedicated efforts. They are facing major challenges, obviously, and stories of the sort that I cited here, which completely dominate. Every story on that page sends a negative message with respect to market integrity and investor confidence. We need to keep driving hard to clean this situation up so we do not get those kinds of stories dominating the press day in and day out.

I think we are making important steps, and I am pleased that Chairman Donaldson is in place, as I have indicated in the past. But, obviously, he and his fellow Commissioners have major challenges ahead of them, and we need to work closely with the SEC in all respects in order to help clean up this situation.

Thank you very much.

Chairman SHELBY. Senator Hagel.

COMMENTS OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, I have no statement, and I appreciate your holding the hearing and look forward to the Chairman's testimony.

Thank you.

Chairman SHELBY. Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Mr. Chairman, I appreciate your holding the hearing, I appreciate Chairman Donaldson being here, and I would submit my statement for the record.

Chairman SHELBY. Chairman Donaldson, your statement will be made part of the record in its entirety. You proceed as you wish.

STATEMENT OF WILLIAM H. DONALDSON CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Chairman DONALDSON. Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thanks for inviting me to testify today on the Securities and Exchange Commission's recent initiatives to enhance investor protections in our securities markets. I appreciate having this opportunity to be here. I want to thank you and your Committee for your continued interest in the issues before the SEC. You are helping us to move our agenda forward, and that is helping to ensure that America's securities markets remain the strongest in the world.

Since its creation in 1934, the SEC's mandate has been to protect investors and ensure the integrity of America's securities markets. That mandate has taken on even greater importance in recent years, as you indicate. With more than 95 million Americans invested in mutual funds, representing approximately 54 million U.S.

households, and a combined \$6.5 trillion in assets, mutual funds are a vital part of this Nation's economy. While much of the public focus over the last few years has been on the events surrounding public companies, the Commission has undertaken an aggressive agenda to identify and address challenges in the mutual fund industry, an agenda that helps us to protect this vital segment.

It is critical that mutual fund investors have access to reliable information on which to base their investment decisions. In this regard, we continue to emphasize the importance of full and fair disclosure of fund fees and expenses. I would like to summarize for you several rulemaking initiatives that are designed to give fund shareholders a better understanding of their fees and expenses.

Just last week, we adopted rule amendments to modernize the mutual fund advertising requirements to encourage more responsible advertising. The new amendments require that fund advertisements state that investors should consider a fund's fees before investing in it and must include information about the fund's investment objectives and risks, as well as an explanation that the prospectus contains this and other important information.

The Commission also, last week, proposed new rules under the Investment Company Act that would broaden the ability of one fund to acquire shares of another fund, so-called "funds of funds." The proposal included improvements to the transparency of the expenses of these funds to further assist investors.

We have also proposed that mutual funds be required to disclose, in dollars and cents, the amount they effectively pay by being invested in a fund over the reporting period.

We also anticipate taking actions to improve the disclosure of breakpoint discounts on sales loads linked to the dollar amount of purchases. We want to ensure that investors understand those discounts and are receiving them.

Another area we are looking at is the need to increase investor understanding of the incentives and conflicts that broker-dealers have in offering mutual fund shares to investors. Initiatives we are considering in this area include a comprehensive revision to mutual fund confirmation form requirements to highlight these conflicts.

While a critical component of investor protection is ensuring that investors have the information they need to make an informed investment decision, it is also important that the funds and their adviser have strong internal controls and governance structures. So, in addition to its disclosure initiatives, the Commission has also focused its rulemaking efforts on fund governance and internal compliance issues.

In February, the Commission proposed rules aimed at ensuring better compliance with regulations governing mutual funds. These rules would mandate that funds and investment advisers maintain comprehensive compliance policies and procedures reasonably designed to prevent violation of the Federal securities laws. Additionally, I would note that we diligently have applied the provisions of the Sarbanes-Oxley Act to mutual funds in every way we could. While many characteristics of mutual funds are different from those of publicly held issuers, we are able to tailor our rulemaking to account for these differences in every case as dictated by the legislation.

We have also included mutual funds in initiatives to increase shareholder participation in the director nomination process. Last month, we proposed rule changes that would strengthen disclosure requirements in operating companies and mutual funds related to the nomination of directors and shareholder communications with directors. The enhanced disclosure provided by the proposal should benefit fund shareholders by improving the transparency of the nominating process and board operations, as well as increasing shareholders' understanding of the funds in which they invest.

I understand that the Committee is interested in getting an update on a few other issues for today's hearing, so let me just briefly bring you up to speed on those areas.

Since June of last year, the SEC staff has conducted a comprehensive study focusing on the investor protection implications of the significant growth of hedge funds. Just yesterday, as you mentioned, the SEC staff released a report that outlines factual findings, identifies concerns, and recommends certain regulatory and other actions to improve the current system of hedge fund regulation and oversight. The full text is available through the SEC website.

While I am looking forward to studying the staff's report and receiving comments from the general public in line with the recommendations that have been made, I will say, as I have said before, that I believe that the Commission needs to have a means of examining hedge funds and how they operate. Speaking only for myself, I believe that the registration of hedge fund advisers would accomplish this.

While I am on the topic of hedge funds, let me update you about our involvement in recent allegations regarding a hedge fund's practices in late trading and market timing of mutual funds. We have put in motion an action plan to vigorously investigate this matter, assess the scope of the problem, and hold any wrongdoers accountable. And we will do so in close coordination with State regulators. I have also asked our staff to study whether we need to take additional regulatory steps to address these concerns.

Now I would like to turn to an issue that is important both from a regulatory standpoint and from the standpoint of the investing public: The critical need for sound governance practices by self-regulatory organizations. I believe that self-regulatory organizations should be exemplars of good governance. At a minimum, SRO's should demand of themselves the same high standards of governance that the New York Stock Exchange and Nasdaq propose for their listed issuers in the wake of several widely publicized corporate scandals. To further that goal, this past March, I directed each self-regulatory organization to undertake a review of its own governance practices.

Since then, disclosure of the compensation awarded to the former Chairman of the New York Stock Exchange has heightened the scrutiny that the Commission, the securities industry, the investing public, and the media are paying to exchange governance standards that reflect the highest commitment to independent and transparent decisionmaking. Prior to the current controversy, the NYSE and a few other self-regulatory organizations instituted special governance committees to further study how their structures and proc-

esses might be improved. I applaud those efforts, but I believe that more remains to be done. I understand that the New York Stock Exchange's new interim Chairman, John Reed, intends to reexamine these governance issues in more depth. I look forward to working with Chairman Reed on this important initiative.

Finally, the Committee requested an update, since my testimony on May 7, on the status of the research analyst global settlement, the SEC's portion of which was filed with a Federal court on April 28, 2003.

Since the filing of the proposed settlement agreement with the Federal court, U.S. District Court Judge William H. Pauley, III has issued a series of orders requesting that the parties—both the Commission and the participating firms—submit additional information to the court relating to the terms of the settlement. We have done that and are awaiting the court's action.

That concludes my formal testimony. I would be pleased to answer any questions that you may have or hear any observations. Thank you.

Chairman SHELBY. Thank you, Mr. Chairman.

Mr. Chairman, many press accounts have stated that it is untenable for a regulator to be simultaneously running a business. Some argue that if the business of price discovery and trading is the New York Stock Exchange's dominant concern, then it may be time for the SEC to consider whether there should be a separation of regulatory functions of the New York Stock Exchange from the business functions.

In recent comments, Mr. Grasso reflected the predominance of business concerns at the New York Stock Exchange by characterizing himself as "two-thirds businessman and one-third regulator."

Mr. Chairman, should the New York Stock Exchange separate its regulatory function from its business operations?

Chairman DONALDSON. That is a complex question. As you know, going back to the original securities acts in the 1930's, I think the then-Commission implementing those acts did what was then a very wise thing, which was to include in the self-regulatory organization a regulatory mechanism, build it down to the operating level so that the regulation would not be part of a large government bureaucracy. They left that to the SEC to oversee, basically regulation that was embedded with practitioners. And, through the years, that has worked pretty well, with some noticeable exceptions.

However, we are at a stage now, in my view, where we really have to reexamine the locus of the regulatory mechanism, and there are many different ways of achieving that, which is now embedded in the Stock Exchange mechanism.

I think the key issue here is how the regulatory mechanism is financed, where the funds come from, and also, where it reports to the governance structure. And that leads into the governance structure. You must have, in my view—and this is what the New York Stock Exchange is working on right now in the form of John Reed as new temporary Chairman—a broad structure which avoids the obvious potential conflicts of interest inherent in those that are being regulated riding herd on themselves.

Chairman SHELBY. That is hard to do, though, is it not?

Mr. DONALDSON. Pardon?

Chairman SHELBY. It is going to be hard to do. You want to do business, and then you are regulating, too.

Chairman DONALDSON. Yes. I think that there are a number of different approaches to this. I had the opportunity yesterday to discuss this with John Reed. We have done some thinking of our own. But I believe that the first step here is for the New York Stock Exchange to get at its own governance structure.

Chairman SHELBY. It goes to corporate governance, does it not?

Chairman DONALDSON. It goes to the corporate governance. It goes to the representation on the board by practitioners, security industry practitioners, the member firms. It goes to the independence of the directors. As you suggest, it goes to just how do you maintain a regulatory mechanism and yet not have it subjected to not only the potential conflicts of interest inherent in board membership, but also have it basically influenced, if it is, by that aspect of the Exchange which is a business.

In the final analysis, the New York Stock Exchange is a competing market. One of the issues that we have is to make sure that that competition is fair competition and to make sure that investors are protected. But in the final analysis, within the rules we set down, it is a business. It is a competitive business, and it cannot be subjected to or sublimated, if you will, to the regulatory role that is resident there.

Chairman SHELBY. Mr. Chairman, many are questioning why it was the Attorney General of New York Eliot Spitzer and not the SEC that discovered and initiated the current investigation involving trading practices in the mutual fund industry. Does it concern you, as the Chairman of the SEC, that a whistleblower first reported a violation to a State Attorney General rather than to the SEC? And what are you doing to coordinate investigations and enforcement action with the States?

Chairman DONALDSON. Well, I wish the whistleblower had reported it to us. On the other hand, I believe that legitimate whistleblowers, no matter where they report, are welcome.

I think that if your question goes to, you know, should we have picked up the collusive arrangements between a hedge fund and—

Chairman SHELBY. Or even reached out to people that would apprise you of such things.

Chairman DONALDSON. Well, the allegations against the Canary hedge fund with the mutual fund it is alleged to have colluded with, that was very hard to find—a design that is designed to cloud an illegal act between two parties. And I suspect that, in a normal look at mutual funds, it would have been tough to find that. If we—and this gets back to the hedge fund report by our staff—had the right to go into that fund, hopefully we would have combined that with the ability to inspect on the other side, and we would have discovered it. But we did not, and I suspect as we go on down here in all aspects of what we are doing, there will be people who have special knowledge of collusive and illegal acts who serve as whistleblowers. And I do not think we will be the recipient of all those pieces—I want to assure you that we do look into every accusation like that, but I suspect we are not going to get all of them.

Chairman SHELBY. Will you be looking at all the mutual funds to see if what has come out lately is widespread in the industry?

Chairman DONALDSON. Yes.

Chairman SHELBY. And do you have the people to look at it? And if not, why not?

Chairman DONALDSON. Basically—I was looking into the entire program that we underwent once that accusation was made. We have been in touch via letters to some—I think 75 percent of the mutual fund industry—requesting their comments on how they handle so-called trading, late trading aspects and the pricing aspects. We have been in touch with the various trade organizations asking them to go out with letters and warnings to the members of those trade organizations—

Chairman SHELBY. Wait a minute. Not just warnings. Will you be, at the SEC, doing the probing yourself to see if this is a widespread practice?

Chairman DONALDSON. Absolutely. That is exactly what we are doing. And we are putting considerable resources into that. We view this as a very important aspect of what we are doing. We want to either find out—hopefully, we do not—that this is a broad-based practice, or we want to find out that it is not.

Chairman SHELBY. Senator Sarbanes, thank you for your indulgence. I am way over my time.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman Donaldson, before I get to some specific matters, I want to ask a question about a time frame. You are now looking at mutual funds—you have got an ongoing investigation. And you have just published a hedge fund report. Only yesterday, you met with the interim head of the New York Stock Exchange concerning the corporate governance practices and many other aspects of its activities.

In March, you directed each self-regulatory organization, not just the New York Stock Exchange, to undertake a review of its own governance practices. The SEC is considering rules with respect to investors' ability to nominate and elect corporate board candidates. And there are other matters as well that I have not mentioned.

When we were discussing the Sarbanes-Oxley Act and we had Chairman McDonough of the Public Company Accounting Oversight Board here just a short while ago, the general view was that by the beginning of next year, next calendar year, that framework would be fully in place, and so that all the actors would know the framework within which they were working.

My question to you is: When do you realistically anticipate that, with all these other areas in which you are working—and I know as days go by new things come to light—reach the point where a framework has been fully into place and you can then say to people, well, these are the arrangements under which you must operate, you need to adjust your practices to conform to them, and then get on about your business?

I think it is very important to try to get that settled as quickly as we can without giving up doing the quality work that is necessary. But do you have any sense in your own mind as you look out over the landscape when you may be able to get all of this into place?

Chairman DONALDSON. Are you referring—

Senator SARBANES. I know your staff has been working overtime now for more than a year, and I respect that. But we have to get this thing up and settled, so to speak.

Chairman DONALDSON. Are you referring specifically to the mutual funds, Senator, or are you referring to some—

Senator SARBANES. And the hedge funds, the corporate governance at the Stock Exchange, the shareholder—the whole agenda.

Chairman DONALDSON. It is a pretty broad question, and I think there are different timetables in different areas. Let me say in the mutual fund area, you know, as far as fees and expenses and that thing, this month we will be—we have put forth some specifications on mutual fund advertising rules, which, in effect, will get at the whole fee structure, if you will, in terms of public disclosure. We are looking at now a comprehensive revision of mutual fund confirmations. And I have to remind you that this—you know, we are affecting a huge business, and we are incurring all sorts of attitudes toward what must be disclosed, and we are looking at the expenses of doing that. You know, we are trying to act deliberately but not precipitously in all these areas.

I think that in terms of the governance aspects of the Sarbanes-Oxley Act, in terms of the corporate world, if you will, all of the regulations are in place now. I mean, we have the independent audit committees. We have the new responsibility for the audit committees. We have a whole series of things that are there. The rules are there. PCAOB is going to be exercising its responsibilities in terms of the function of auditors and accountants and so forth. So that is in place.

On the hedge fund report that we have just received, the staff has made specific recommendations, and the process now is for us to receive comments from all interested parties as against not only the report itself, but also the recommendations in it. And I would hope that within a relatively short period of time we will have gathered all of those comments, and then the Commission itself can make its decision.

There are some uncertainties here on the hedge fund thing. There are uncertainties as to costs, resources, et cetera, et cetera. But we will be well into it in the early part of next year.

Senator SARBANES. Well, do you think the end of this year or the early part of next year is a reasonable timetable to get all these things into place?

Chairman DONALDSON. For some of these things, yes. For some, not. For some, we need to do more research. I cannot emphasize enough that we cannot be precipitous. We have to be careful. We have to be sure that some of the things we are doing do not have unintended consequences. After all, we are setting rules for the long haul here, so that I think we need to pursue this with all deliberate speed.

I also would say that we are in the process of building our staff, and we are well along in that, and that is going to give us more resources. I would say something else in terms of some of the impact of some of the rules and regulations we are putting in, and that is that we have a management effort underway now to orga-

nize ourselves in two ways that I think will attack both our deployment of resources and the rapidity with which we can take action.

In terms of the deployment of resources, we have to get a lot smarter than we have been in terms of looking around the corner and over the hill and anticipating problems. And we have to get a lot smarter in terms of how we deploy our resources and using sampling techniques and efficiency techniques—we have to get more efficient in the way we uncover things. We cannot just go out after everything. We have to get more efficient in the signals that we get and how we act on signals to concentrate our efforts in areas of high concern.

Senator SARBANES. May I ask one more question?

Chairman SHELBY. Go ahead.

Senator SARBANES. I want to ask just one more question. I think it is important as you are doing this to make systemic changes that may diminish the likelihood of abuses happening, in addition to punishing the bad apples. But, for instance, it seems to me on these late trading mutual funds, you have got to figure out some changes in the system that inhibit that kind of practice as well as go after the ones who have been engaged in it. And I think the industry itself needs to be thinking about how they can do that.

In that regard, one systemic change that might be made with respect to corporate reform addresses this *The Wall Street Journal* full-page ad that was California Public Employees, the Connecticut Retirement Plan, New York State Common Retirement Fund, AFSCME, about open access for shareholders as the next critical step of corporate reform. And they have a number of proposals with respect to giving investors timely access to the ballot. They seem to be sensitive to guarding against corporate raiders or hostile takeovers, which is one concern that has been raised.

I appreciate it is a complex situation, but if that can be structured, then the shareholders, particularly these big institutional investors, may become part of the system of assuring responsible behavior on the particular of management as it is translated through the shareholders to the board of directors and then to the management.

Where is the SEC on these questions of open access for shareholders?

Chairman DONALDSON. Well, as you know, this is an area of considerable concern for us. The issue of shareholder participation in the election of directors has been around for a long time, and not a lot has been done about it. And we intend to propose measures to do something about it.

Now, there is a trade-off here. There is a trade-off between the efficiency and effectiveness of a corporate board of directors constituted by people who are working in the best interests of the corporation, as opposed to a model that would have representation that has separate agendas, constituency interests, and so forth, which could result in a malfunctioning board.

So we are trying to go down a narrow path here which says that there should be some measure of shareholder participation in the selection process of directors if there is evidence that large numbers of shareholders' wishes are not being reflected at the board level. If, in fact, in proxy materials a proposal is put forth year

after year that receives a large number of shareholder votes and a corporation does not do anything about it, then we say that is when there should be a way that shareholders could propose somebody for the board. But that somebody for the board cannot be—has to go through the same thing that any board member would in terms of conflicts of interest. We cannot put competitors on the board, or we cannot put people that have some a vested interest on the board. It has to be a truly independent shareholder, not paid for by somebody else, et cetera.

So that is a long way around saying that we are working very hard on a proposal. We have it out there now in terms of our general direction, and you will hear from us very shortly on some specific rule proposals that get at some of the things I am discussing.

Senator SARBANES. Mr. Chairman, I may revisit that, but thank you, Mr. Chairman. My time is up.

Chairman SHELBY. Thank you, Senator Sarbanes.

Senator HAGEL.

Senator HAGEL. Mr. Chairman, thank you.

Chairman DONALDSON, welcome. As you know, the SEC, OFHEO, and the U.S. Attorney's Office in Alexandria are looking at management and financial accounting issues regarding Freddie Mac. Can you give this Committee some sense of timing as to the SEC investigation, when you are anticipating to have a report, and maybe a status on where you are in that investigation?

Chairman DONALDSON. As you know, Senator, Freddie Mac has agreed to voluntary registration of its shares, and we were working with them to get them prepared for the voluntary registration of their shares.

Up until now, we have not been their regulator, so that there are two things going on here. There is the internal investigation going on in Freddie Mac by its regulator, which we do not have anything to do with. There are our efforts to get them to a point of conformance with our registration rules and regulations. We do not control the timing of what is going on with the other regulators.

What we do have an interest in, even though they are not registered with us now, is evidences of fraud. And if there is evidence of fraud, even though they are not registered, the impact on the marketplace, we would have a role there.

Senator HAGEL. Are you reviewing that now?

Chairman DONALDSON. We are looking at that right now, yes.

Senator HAGEL. Can you tell us anything more about that?

Chairman DONALDSON. No, I really cannot at this point.

Senator HAGEL. But you have it under active review—management and accounting?

Chairman DONALDSON. Yes, we are in touch with them, and we are interested in any evidence of fraud that there might be or might not be.

Senator HAGEL. Thank you.

As you know, the Nasdaq market has been in the process of trying to complete its separation from the NASD for 3 years. I know they have an application in with the SEC. Can you give us a sense of where that is?

Chairman DONALDSON. Basically, the NASD and the Nasdaq market itself has applied to be classified as a stock exchange, and

there are certain qualifications under the Securities Act as to what constitutes a stock exchange, and part of that—without getting too detailed—it has to do with opportunities for order interaction and pricing improvements such as exist on the New York Stock Exchange. And right now they do not qualify. And we have been in discussions with them to see if we can get some modification in their approach. We also are concerned, as we are with the issue of public ownership. The Nasdaq market has, in effect, backed into public ownership. I mean, there is public ownership of the Nasdaq market, and that brings into focus what oversight or board governance measures one would have if it should happen in the future that there would be a large external owner of that—what protections could be built into the board of directors and in the event of more extensive ownership, and with some other securities markets, perhaps even total ownership by somebody other than the members of the Exchange. And that is an area that we are working on very hard right now.

But I assure you that we are not just sitting on the Nasdaq application. We are trying to integrate that and our concerns with it, with our concern for the overall market structure issue. We are in a period now where, with the advent of nanosecond-trading, with the advent of the ECN's and so forth, we are in a period where the whole market structure issue needs to be reviewed, and we are in the process of doing that. And that is going to take some time because it is a very complex issue, and I think this gets back to Senator Sarbanes' question.

When we step back from all of this, when we step back from the press reports and look at the American market system, including the New York Stock Exchange, the Nasdaq, the regional exchanges, the ECN's, and so forth, we still have the best system in the world. And we have to be very careful, as we try to change it and modernize it and accommodate the technology that has come into being, that we do not make some false steps here that would destroy our market and have it go somewhere else. And that is why we want to pursue all of this with deliberate speed but not haste with the unintended consequences we would regret.

Senator HAGEL. Thank you.

Mr. Chairman, thank you.

Chairman SHELBY. Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman. Thank you for holding this hearing, and I welcome Chairman Donaldson. Like many others, I think you are doing an outstanding job, but the array of issues is pretty remarkable, as we have discussed as we have gone through.

I am going to focus on the mutual fund industry primarily today, but it is not because I do not have interest in the kinds of things that Senator Hagel and others are talking about, because they are really key. But it strikes me that when we look at the issues that are on the table with regard to mutual funds, they have a lot of overlap in the kinds of issues that preceded Sarbanes-Oxley and corporate America and other places with regard to corporate governance and now we see echoed in the New York Stock Exchange.

Isn't it time when the requirement is only that 40 percent of the directors of mutual funds be independent and that there is no independence question with regard to the chairman and that many of the mutual funds are embedded in organizations that benefit both from sales practices and as the discussion on fee disclosure shows, is not it time for independence to be brought to the corporate governance structure? And are you pursuing that? Do you believe that is the direction that needs to be taken along with—and I will follow this up—another element that I think is a model or circumstance that flowed from Sarbanes-Oxley? Do we have enough staff to actually provide the checks and balances from the regulatory side to be able to look at the mutual fund industry in a consistent way that we do not run into a situation where we think we are regulated, but we are really not because we do not have the ability to actually go through and bring the kind of discipline to the process that is necessary?

So it is really on two fronts: First, the governance concepts, which I think really gets at a whole series of things, whether it is fees, whether it is the intermixing of hedge funds and mutual funds management. I would like to hear your views on that. And then, second, with regard to do you have enough staff to be able to apply the same kinds of standards that you might in other areas? We certainly had to grow staff when we are talking about looking at implementing Sarbanes-Oxley. We looked at the number of accountants, the number of people that were involved in the enforcement area, whether it was adequate. Is it adequate today with respect to the mutual fund industry?

Chairman DONALDSON. Well, let me address the staff issue first, Senator. As you know, we are in a major build-up of staff. We are trying to do that again, deliberately. We are not just out hiring willy-nilly. We have a system going now in which we are going to be very quality conscious. And I am pleased to report that, you know, we really could only get going on some of the nonlawyer hiring as recently as July. And we now are going full blast, and we are hiring. So we will have additional resources.

Are those resources adequate to do all the tasks before us? I would reemphasize what I said before, and that is that we have to be more effective in the way we use our staff because we have to have—to put it in industrial terms—a productivity improvement, if you will, so that we are concentrating our people on areas of high risk, high need, and high potential for investor problems. And I think that we have only just begun to concentrate on that.

So, I cannot answer you yet in terms of do we have enough people. I think we do—I think we will have by the end of this year, and I think we will have implemented some of the things that I am talking about in terms of early warning systems and so forth that will help us be more efficient.

Senator CORZINE. When you are looking at your priorities, though, is the mutual fund industry one of those areas where you believe that there is need for additional staff and—

Chairman DONALDSON. On which part?

Senator CORZINE. In the mutual fund industry itself. It is a specialization that is somewhat different than—

Chairman DONALDSON. I think that right now we are pleased with the build-up that we are having in that staff right now. We think it is going to be adequate to what we have on our agenda.

The Investment Company Act rules require a majority of independent directors. I am now getting into your second question here. And I would like to make a general statement, which is that in addition to the rules and regulations that are in the Investment Company Act, in addition to the changes that we either have made or are not making, I believe we are heightening the awareness of the directors of mutual fund companies. I think we are heightening awareness of the responsibility similarly for just regular industrial corporations. And the real impetus that will reduce the need for our staff to expand and expand and expand is if the mutual fund industry and corporate America will take it upon themselves not to just wait for the rules to come along, but to change their processes, to realize where there are conflicts, to realize where there is too little sunshine in terms of disclosing, what, you know, the costs of mutual funds are, et cetera. I mean, that is the old saw of corporate responsibility, in this case mutual fund management responsibility. And I am hopeful that we are going to see some changes in that area that are self-imposed rather than thrust upon them by rules.

Senator CORZINE. Do you have a view on the independence of the chairman in mutual funds?

Chairman DONALDSON. On the?

Senator CORZINE. The independence of the chairman of a mutual fund board?

Chairman DONALDSON. My own personal view on that is to try to make myself available and listen to the arguments on both sides. The industry believes that there is a certain efficiency involved with a chairman that is intimately involved with a number of funds and knows—as opposed to somebody totally independent with no knowledge of the industry, somebody that is familiar with a fund group and how it operates. There is some merit to that.

I feel ultimately that there needs to be more independence in that chairman role, but we are balancing that and looking at it.

Senator CORZINE. Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Chairman, before I call on Senator Bunning, I think that you are absolutely right that we have raised—everybody, the public, the media, and the people—the level of debate on all of the issues involving integrity, conflicts of interest, and self-dealing in the capital markets, including mutual funds, perhaps. The question is: Where do we go from here? And how long is it going to take? I was thinking of some questions Senator Sarbanes was asking.

Senator BUNNING.

COMMENTS OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman, for holding the hearing. And thank you, Chairman Donaldson, for being here.

In your staff report on hedge funds released yesterday, the staff looks at requiring hedge fund managers to register with the SEC as investment advisers. Does the SEC have the resources to take

on this new responsibility, especially in light of the fact that there could be up to about 3,000 new registrations?

Chairman DONALDSON. Right. Well, I think that the first-level response to that is that we would—if the Commission does decide to require registration, it would be the regular—the forms and what information we are requiring would be tailored to particular interests that we would have in the hedge fund industry. So that is the first level.

Senator BUNNING. Well, wouldn't transparency be the number one issue that all of us are looking for, according to *The Wall Street Journal*, according to the general consensus of the American people, a little more sunlight into what really hedge fund—what function they perform?

Chairman DONALDSON. Well, that is a very important part of what we are interested in. However, I would say that what we have not concluded is that certain of the proprietary techniques used in hedge fund management, some of the ways the funds are managed—you know, we do not feel that it would be fair to require disclosure of that in a competitive environment, unless we saw evidence of the fact that the techniques were somehow impacting the marketplace in a way that needs to be regulated. There are other things that we are interested in.

Senator BUNNING. But we have evidence, obviously, or at least there is very strong evidence that hedge funds have been bending the rules, in fact, stepping over the line as far as mutual funds purchases. Anybody that is at all familiar with investments knows that if you buy after the close at the close price and then you can sell in the morning at the morning opening, you have a chance to build in a profit.

Senator SARBANES. You are telling me.

[Laughter.]

Senator BUNNING. Big time.

Now, if that is what a hedge fund is doing, you should be able to stop that. You are not the regulator, but you should be the regulator of hedge funds.

Chairman DONALDSON. Well, there are two parts to that. It takes two to tango. It takes the hedge fund, and it takes the mutual fund that it is dealing with.

Senator BUNNING. That is correct.

Chairman DONALDSON. You are absolutely right in terms of both sides need—the mutual funds have made their own efforts to close down the kind of trading that you talk about by higher fees, redemption fees, et cetera. The issue here is whether they have tried hard enough, and an even bigger issue is whether they have aided or abetted those kinds of transactions. And there is some evidence, at least in one fund—and we are looking at it. Whether it is more widespread or not remains to be seen.

On the hedge fund side, I think that what we are looking at is the registration of the hedge funds so that we can go in and see what they are doing. And, again, on the Canary situation, had we been able to be on both sides of that, we would have had a much higher probability perhaps of catching it. And I do not wish to imply that we are going to catch every—

Senator BUNNING. I only get 5 minutes, so let me—

Chairman DONALDSON. Go ahead.

Senator BUNNING. Let me get into derivatives, because I worry daily about derivatives and their use in our markets today. Now, I know there are certain investors who have big concerns about derivatives, and I know that the Chairman of the Federal Reserve thinks they are wonderful things. But I worry about the regulation of derivatives, the same as I worry about the regulation of hedge funds.

What is the SEC doing to make sure that derivatives are used properly?

Chairman DONALDSON. I share your concern about the use of derivatives and the risks that are out there and the lack of knowledge that exists. Clearly, the Federal Reserve is involved in this, was intimately involved in the Long-Term Capital instance where derivatives almost caused—or did cause—a big flap.

Senator BUNNING. Yes.

Chairman DONALDSON. And almost a major failure.

I think that we are doing everything we can to understand the impact of derivatives and the potential impact that they can have. But it is not just we that can do it, I mean, because they are so pervasive into areas that we do not regulate—foreign banks and other entities which use these instruments. And I think it is a matter of concern. We have the President's Task Force where the Chairman of the Federal Reserve, the Chairman of the SEC, and the Chairman of CFTC get together and their staffs get together, and this is one of the issues that is discussed at those meetings.

Senator BUNNING. All I can tell you, Mr. Chairman, is that the American investor who had implicit confidence in the markets at one time, they do not now. And unless the Securities and Exchange Commission in their regulatory function can instill back that confidence by doing something and overseeing the markets better, we are never going to have the same confidence that we had 30 years ago, 20 years ago in our markets, and that is absolutely essential if this country is going to move forward. We cannot have the productivity of the American worker and our GDP advancing with a no-growth-job economy unless people trust our regulators. And I am just saying that as a matter of fact. And not only you as a regulator, but also all those who are regulating everything else government-wise.

So, please, please, with haste and with due diligence, get your job done.

Chairman DONALDSON. Senator, if I can, I believe that goal is the top goal for me and for the Commission, and that is trust in us as a regulator.

I just have to say, as an aside on derivatives themselves, that there are aspects of derivatives that are helpful. Insofar as derivatives shift and share risk, the case could be made that we have avoided a lot of disasters because of the judicious use of derivatives to lay off risk and spread it around.

So we have to be very careful that we do not throw out the good with the bad.

Senator BUNNING. One of the smartest investors in this country said, "It is a ticking time bomb." And I do not have to tell you who that is.

Chairman DONALDSON. And he had another very smart investor on the other side, who currently is Chairman of the Federal Reserve, who disagrees with him.

Senator BUNNING. Well, it is easy to invest in Government bonds. Chairman SHELBY. Senator Miller.

COMMENTS OF SENATOR ZELL MILLER

Senator MILLER. Thank you, Mr. Chairman, for holding this hearing, and Mr. Chairman, thank you for being with us and for the job you are doing and the way that you have responded to the questions.

The questions that I came prepared to ask have already been asked, but I think I would ask: Would you care to comment on the current working relationship between the SEC, the State securities administrators, and the State attorneys general on resolving the various enforcement issues that have arisen, and do you think there are any changes that may be needed to be made in the SEC's relationship with the States?

Chairman DONALDSON. It is an excellent question. It is one that we are very concerned about. Let me just say this, that we need and encourage all the help we can get from local regulators in the securities industry at the local level where they can uncover and investigate things that go beneath our screen, so that if there is malfeasance or fraud or whatever at a local level, we welcome the local administrators and securities administrators.

At another level, and that is the level of the structure of the markets themselves, we believe and I believe very strongly that we cannot have 50 different structural solutions, we cannot have 50 different ways, perspectives as they are put out, and trading rules and so forth. So that, if the solution or the fine is followed by some structural change. I believe that that has to be done by the Federal administrators.

Having said that, we need to and we have cooperated with local securities regulators. Just 2 weeks ago in connection with the chairwoman of the State regulators trade association, we agreed to enter into a joint arrangement with them to see if we could not improve communication and cooperation. That will go a long way.

I will say it again and in frank answer to what you said, there are areas where a local authority can step in too late to an investigation that is already under way and in so doing interrupt a carefully put-together investigation by a Federal functionary, and this is where I think we get into trouble, where there is considerable work that has been done, cases being built, and someone comes in from left field and does not really add anything and in fact might create an environment where the accused will get off because of a technicality.

Senator MILLER. Thank you.

Chairman SHELBY. Senator Allard.

COMMENTS OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, thank you very much. I have a statement here that I would like unanimous consent to be included in the record.

Chairman SHELBY. Your statement will be made part of the record, Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

I would like to explore a little bit the Investment Company Act of 1940 and whether or not any amendments may be needed to bring it up-to-date or whether it is okay the way it is.

I understand that in order to manage a mutual fund effectively, generally, what is required is that the SEC has to grant about 8 to 10 exemptions from the Investment Company Act and that many times, the SEC may or does impose conditions of its own as a condition of granting those exemptions.

Am I correct in that?

Chairman DONALDSON. I did not get the last part, Senator.

Senator ALLARD. That in addition to the 8 or 10 exemptions from the Act, you have your own conditions that you also place on the applicant and in the management of the mutual fund.

Am I correct in that?

Chairman DONALDSON. Yes.

Senator ALLARD. Okay. If so many exemptions from the present Act are required to do business, do you think the Act should be brought up-to-date to reflect present-day realities?

Chairman DONALDSON. At the present moment, we think we have the authority, rulemaking authority, under the Investment Company Act to do what we think needs to be done. That could change, but at this juncture, we do not think we need—

Senator ALLARD. The exemptions that you grant on a fairly regular basis, is the nature of these exemptions time and time again, or are they variable depending on—

Chairman DONALDSON. Yes. A perfect example of that would be the rules that will allow the so-called “fund of funds” to not require an individual exemptive under, would allow a mutual fund to buy another fund that might have a different objective—a mutual fund that might own stocks and want to buy a money market fund. Right now, we give exemptions for that being done, and we are changing that now so that that can be done without the—

Senator ALLARD. Where they use the money market funds more or less as a holding fund, and then you have your investment fund over here.

Chairman DONALDSON. Right.

Senator ALLARD. The Investment Company Act gives the SEC explicit authority to sue investment company management for charging excessive fees and imposing a fiduciary obligation on the adviser with relation to receiving these fees. How many times has the SEC used this statutory authority?

Chairman DONALDSON. I cannot tell you that off the top of my head, but I will get the answer to you, Senator.

Senator ALLARD. I think it is—

Chairman SHELBY. You may furnish that for the record.

Senator ALLARD. We would like to have that as a part of the Committee record, if you would, please.

Chairman DONALDSON. Sure.

Senator ALLARD. Now, the same power is given to any shareholder of the fund and to the SEC to intervene in any such action, and you may not know how often this has occurred, but if you do,

I would like to have you share that with the Committee now; if not, we would like to have that as a part of the record also.

Chairman DONALDSON. We will be glad to give you that.

Senator ALLARD. Thank you.

Given the extensive enforcement powers provided to the SEC under the Investment Company Act, do you find the need for amendment of the Act to empower the SEC further? I think you answered that question earlier, and the answer is "No"—you are comfortable with what you have. Is that correct?

Chairman DONALDSON. Right.

Senator ALLARD. Okay. I have one other area that I might explore with you a little bit. Middle-class and individual investors have seen a rapid expansion of the investment opportunities available to them and particularly many more individuals are investing in mutual funds which can help them save for their children's college education or for their retirement.

Has the Commission considered in its new initiatives regarding mutual funds how important is the balance between individual investors and large institutional investors, such as what was brought up here by the Senator from Maryland?

Chairman DONALDSON. What do you mean by "balance," Senator?

Senator ALLARD. We have individual investors out here, and then you have the whole, large mutual, bloc investors, retail. How do you balance their interests?

Chairman DONALDSON. Well, there are two parts to that question. One is the interests in terms of access to a different source of investment vehicles, if that is what you are talking about.

Senator ALLARD. Yes.

Chairman DONALDSON. And I think that is a balance that is brought up in the hedge fund report by the staff in terms of the various safeguards there for minimum assets and earning power and so forth for individual investors getting into the, "hedge fund" kind of vehicle. I think you are talking about the issue, as you move from retail into larger and larger purchases, there are discounts allowed, and trying to make sure that people are protected as they get to be larger investors by the discounts they get for buying more.

That is one whole side of your question. The other side is the protection of individual investors in the marketplace itself trying to buy and sell stocks versus large institutions trying to buy and sell stocks. I think the hallmark of our system has been the protection of the individual investor, the protection that allows the individual investor to compete but to compete fairly with people who have more muscle. And that gets to market structure, it gets to issues such as price improvement, and it gets to the way the central marketplaces are organized, and that is what we are working very hard on, to make sure that the individual investor is protected.

Senator ALLARD. Thank you.

I see my time has expired, Mr. Chairman.

Chairman SHELBY. Thank you, Senator.

Senator ALLARD. It is amazing how fast it runs when I have questions, but I am sure it is balanced.

I want to thank you for holding this hearing and reemphasize what so many Members of this Committee have said previously,

that we have to maintain the confidence of the investor—that is what it is all about—and if we do not do that, we all suffer.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

Chairman Donaldson, back to mutual funds, if we can. The mutual fund industry has come under scrutiny, as we all know, as investors learn more about the business practices of mutual funds and their brokers. For example, many investors do not realize that their brokers may receive bonuses for selling them certain funds. Are these payments breaches of the fiduciary duties owed by brokers to shareholders, or are investors simply unaware of these common practices?

Do you think that investors believe that brokers have a greater fiduciary duty to them than is currently required by law? Do we need some changes there?

Chairman DONALDSON. This has been an area of inquiry for us, the so-called “incentives,” if you will, or rather, the hidden incentives, for a broker to sell one fund versus another, and we are on a trail of bringing some sunlight to these practices.

Chairman SHELBY. Good.

Chairman DONALDSON. The individual investor has the right to know that if a broker is recommending a particular fund, what outside of the performance and suitability of that fund is inducing the broker to recommend it, and we believe that there needs to be more disclosure there than there is right now.

Senator SARBANES. Would you yield on that, Mr. Chairman?

Chairman SHELBY. Go ahead, Senator Sarbanes.

Senator SARBANES. I think that is a very limited answer. I understood—and the NASD has just disciplined one of its investment banking firms—that there are certain practices that they have a rule about that you are just not supposed to do it, not that you should just disclose it. I mean, they had brokers of theirs promoting the sale of their own mutual funds, proprietary mutual funds, and they were giving them tickets to Britney Spears and Rolling Stones concerts, tickets to the NBA Finals—listen to this one—tuition for a high-performance automobile racing school, and trips to resorts.

The NASD said this was prohibited under their rules, and they levied a heavy fine on them. So, I do not think disclosing it is enough; I think those are practices that just ought not to take place. It is a tremendous inducement to these brokers not to pay attention to the interests of their investors, is it not?

Chairman DONALDSON. There are many different aspects of the way that mutual funds are sold, and I think the first level of understanding here on our part is to understand what those inducements are that the customer does not understand. Now, whether it is illegal to give baseball tickets to a customer of yours, I would really wonder about that. I mean, that is commerce, that is business; you entertain customers, you do whatever you can to get them to do business with you.

Where it reaches some level of illegality, I think is something that we would certainly look at. But I think what I tried to respond to Senator Shelby’s question was that it is not the baseball tickets so much as it is the fact that somehow either the mutual fund com-

pany or the brokerage firm is rewarding, paying, the broker to push a particular fund. I think that is kind of a different issue than the broker having baseball tickets.

Senator SARBANES. For whom?

Chairman DONALDSON. Well, again, I think customer entertainment is part of American business life.

Senator SARBANES. You mean a baseball ticket for the investor?

Chairman DONALDSON. Yes. I mean, if—

Senator SARBANES. What about a baseball ticket for the broker from his brokerage firm, which creates a competition and says to them, “We want to push these proprietary mutual funds; these are our mutual funds”? Was the NASD wrong in what they did here? They fined an investment house \$2 million and censured them, and they fined a supervisor \$250,000 and censured him because they did not have proper monitoring practices. And then it says—this is their release, the NASD—“In enacting the noncash compensation rules, the SEC and NASD recognize that the types of sales contests seen in this case increase the potential for investors to be steered into investments that are less suitable than some alternatives. These rules were designed to prevent the conflicts of interest that might arise for the broker when faced with such a choice.”

Chairman DONALDSON. Senator, I misunderstood your question. I thought you were talking about the broker himself giving baseball tickets to his client. You are talking about—

Senator SARBANES. No, no. I am talking about the investment house running a competition—

Chairman DONALDSON. Yes, you are talking about non-monetary—

Senator SARBANES. —and saying to the brokers, “If you can push a certain number of our own proprietary funds, you will get these Britney Spears tickets” or tuition for a high-performance automobile racing school, so the broker ceases then to meet the suitability test for his clients.

Chairman DONALDSON. Sure. You are talking about nonmonetary compensation. You are talking about even monetary compensation that is not disclosed. And I agree obviously that is a violation of the NASD rule and a violation of our rules, and it is quite correct that action be taken against them. But I misunderstood what you were talking about in terms of whom it was being given to and from whence it was coming.

Chairman SHELBY. Chairman Donaldson, in prior hearings on hedge funds here in the Banking Committee, you addressed problems concerning—which you have alluded to already—the retailization of hedge funds and the conflicts of interest inherent when advisors manage both a hedge fund and a mutual fund.

Chairman DONALDSON. Right.

Chairman SHELBY. Describe how the report’s recommendations address these concerns or will address these concerns.

Chairman DONALDSON. Again, the conflict of interest would be a fund group, let us say, or a manager that on the one hand is running a mutual fund and being compensated for doing that with fees, and on the other hand is running a hedge fund where the compensation normally is not only fees but also a participation in the profits, and the potential conflict of interest as to where securi-

ties that you buy or sell are put. Does an attractive IPO that is bound to go up in price get put in a hedge fund as opposed to put in a mutual fund.

Chairman SHELBY. Yes; obvious conflict.

Chairman DONALDSON. And that is an obvious conflict.

Chairman SHELBY. Mr. Chairman, some people contend that further SEC regulation of hedge funds will drive capital offshore. What is your perspective on this?

Chairman DONALDSON. I do not think that is a worry, because if you have more than 14 U.S. investors, no matter where you are located, you still come under our purview. You cannot escape it.

Chairman SHELBY. They have to do what is right, do they not?

Chairman DONALDSON. Yes. If you have U.S. investors there, it would fall under our jurisdiction.

Chairman SHELBY. I have a couple of things left. The New York Stock Exchange—we hope to hear from you and Mr. Reed when the governance review is complete on the New York Stock Exchange—when do you expect the New York Stock Exchange to deliver its report on corporate governance practices, and when do you expect the New York Stock Exchange to designate a permanent CEO?

Chairman DONALDSON. Mr. Reed, very wisely, has wanted to take a look at the work that the Stock Exchange has done on corporate governance before releasing it or giving it to us in answer to our request, and I think that is done with my total concurrence, because I think that there are issues involved in the corporate governance paper, if you will, that will be changed as a result of a totally new, independent person coming in and having a fresh look at it.

So this is a complex subject that Mr. Reed has undertaken in terms of how to organize the governance of the Stock Exchange to avoid some of the things that have happened here in the last period of time.

I want to emphasize that we should not confuse the governance issues with other aspects of the Stock Exchange management and particularly its regulation. Again, I do not think we should be too hasty to throw the baby out with the bath water. I think the Stock Exchange is going to have to come up with a structure—

Chairman SHELBY. Sometimes you need to give the baby a bath, though, do you not, daily, so to speak?

[Laughter.]

Chairman DONALDSON. I think the Stock Exchange is going to have to come up with a governance structure that guarantees the independence of the regulatory aspect of what they are doing but somehow keeps its proximity so that it is not just a bureaucracy out here somewhere that does not really understand how difficult it is to conform to, let us say, trading regulations.

Chairman SHELBY. Sure. Mr. Chairman, you have already described a lot of the priorities on your agenda at the SEC that you are doing to help bring confidence back to the investor, and to the people. Are there other types of conflicts of interest that you are looking at, that your enforcement division is investigating? For example, in prior testimony before this Committee, you mentioned a concern with tying activities. Where are we there?

Chairman DONALDSON. On what, Senator?

Chairman SHELBY. Tying; tying activities.

Chairman DONALDSON. Tying, yes. Well, we have a set of priorities, if you will, and clearly you are seeing some of them emerge here in terms of the hedge fund study, in terms of the market structure study, in terms of the work we are doing in mutual funds, in terms of all the other things that we are doing in terms of enforcing the Sarbanes-Oxley mandates.

In terms of tying, I think that this is an issue that concerns me in terms of the relationship between providing certain services in order to get other business, and it is a very sophisticated subject. It is one that I think we have to have a constant look at. I think the bank regulators have to have a constant look at it. I do not want to say it is not a priority, but I want to say that it is something that we continue to gather information on.

Chairman SHELBY. I know that it has not reached the priority status such as accounting fraud, corporate fraud, corporate mismanagement, now mutual funds, and so forth. When will you have some type of perspective on how wide and deep the mutual funds problem is?

Chairman DONALDSON. You are not talking tying now; you are back on—

Chairman SHELBY. No. We are talking about mutual funds and the problems that have arisen lately. How deep is that and how wide is it, and if you do not know now, when will you know?

Chairman DONALDSON. I have four or five pages here of different aspects of mutual fund regulation where we are either putting rules in now, contemplating rules, or investigating, so it is hard for me, without getting very specific as to what the timetable on each one of these items is. But I would say that it is a top priority for us to resolve some of the issues we have been talking about this morning. I would think that we are going to work—we have already put into effect a number of things, and we will roll these out over the immediate future.

Will we be finished by the end of 2004? I do not know.

Chairman SHELBY. I believe you are up to the challenge. I just know that a lot of things are in your basket, and they have not been resolved yet, and when one thing seems to be coming along, then we have another scandal or something close to a scandal, conflicts of interest in dealing with mutual funds or capital markets or corporate fraud or something else, and it just undermines investor confidence, as you well know.

Chairman DONALDSON. I am well aware of that. I think a lot about it in terms of investor confidence. It is regrettable that some of the enforcement actions we bring are from the past—in other words, we have finally caught up with it—and it is not new malfeasance, but it is something that happened months or years ago, and yet it hits the newspapers and is greeted as something new.

The thing that upsets me more than that is malfeasance that appears on I would say my watch right now, the continuing to look under a leaf and see things that we do not think should be there. That bothers me.

Chairman SHELBY. You plan to look under the tree and the leaves, don't you?

Chairman DONALDSON. Yes.

Chairman SHELBY. Okay.
 Senator Carper.

COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman.

Welcome, Chairman Donaldson. In the SEC staff report that was issued yesterday, the report notes that there are several benefits that inure from hedge funds, and the report says, "Hedge funds play an important role in a financial system where various risks are distributed across a variety of innovative financial instruments. By reallocating financial risk, this market activity provides the added benefit of lowering financial costs shouldered by other sectors of the economy."

It goes on to say: "The absence of hedge funds from these markets could lead to fewer risk management choices and a higher cost of capital."

That is just part of what the report says, and this is my question: Given the importance of hedge funds in capital markets today and thus the broad market implications of hedge fund regulation, including registration, do you plan to consult with the President's Working Group on Financial Markets prior to any regulatory action that the SEC may take with respect to hedge funds?

Chairman DONALDSON. Well, as I mentioned earlier, the state we are in now is the investigative work has been done over a year; we put out the staff's conclusions with recommendations. The next step is that we would hope to get reactions back from various interested parties, and one of the reactions we would hope to get back is the reactions from the President's Working Group. We would hope to hear their reactions to what our staff has suggested before we make any final decision. So the answer is yes, I would plan to present that to the President's Working Group.

Senator CARPER. Good. Thanks.

The second question is one dealing with SEC's regulatory structure. At other times when you have been before our Committee, I have asked you about the moneys, the additional appropriations that we have provided to the SEC to hire new staff to enable you to meet your statutory responsibilities. In your speech this summer before the National Press Club, I believe you mentioned that you have created a new management structure operating out of the office of the Chairman to help you manage your expanded agenda and expanding resources while promoting cooperation amongst the SEC's various divisions and offices.

You noted that this structure would help the Agency to anticipate issues, not just to react to them. Could you explain a bit more about this new structure and maybe share with us—even though it has not been in place for very long—examples of issues that the Agency has anticipated due to this new structure?

Chairman DONALDSON. Yes. I would begin with a focus from the Chairman's Office on Management itself, and the first step in that has been to change the structure of my office and to bring in three people to perform the role that a chief of staff used to perform—

Senator CARPER. Say that again—bring in what kind of people?

Chairman DONALDSON. People to perform chief of staff junctions. One of the managing executives in my office has most of the func-

tions that the chief of staff used to have in terms of the relationship of the Chairman's office with the other Commissioners and the Commissioners' staffs. That is a chief of staff kind of role.

One of the other managing executives is responsible for our external affairs, to include our relationships with the public and the press and so forth and our relationships with you on the Hill.

The third managing executive is the executive for internal management. This gentleman, Peter Derby by name, brings a long history of operating a very successful new bank in Russia, of all places, where he started a *de novo* bank and built it to great prominence, known for its integrity, and so forth. And Peter Derby is in charge of effecting some of the things that I have been talking about in terms of management of the Agency itself—to wit, we are attempting to get more synergism and cross-fertilization going between the five divisions of the Agency, and I do not have time, and I would be glad to elaborate on that, but we are trying to get much more information-sharing and collaborative work and so forth than perhaps has existed in the past.

Second, we are organizing a series of management controls, if you will, which for lack of a better word, we are calling “dashboards.” These are mutually agreed-upon standards of performance in the various divisions. The word “dashboard” is where we are able, at the senior levels in the Agency, to see what progress is being made in a number of different areas in terms of the amount of time it takes to get projects out, how much progress we are making in the hiring that we have to do, et cetera. It is a way of looking at progress against—I will not say deadlines, but against mutually agreed-upon objectives.

Third and perhaps most important is an attempt to organize a risk assessment or policy planning group outside of the various divisions whose role is to—and I used the words before, and I will use them again—look over the hill and around the corner and try to anticipate problems coming down the pike and to see if we cannot somehow get involved in those problems before hand instead of just playing a mop-up game.

And this is not to imply that we do not have that kind of risk assessment in each one of the divisions, but this will stimulate that work within each division, and we will have a little bit of a longer view. And again, I do not want to promise too much in terms of this effort, but it basically will heighten our anticipatory capabilities so, rather than just reacting to something that has happened or a tip that has come in or whatever, we are out there trying to anticipate what is the next problem area and what can we do about it now.

Senator CARPER. All right. Thanks for sharing that with us.

Thanks, Mr. Chairman.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Chairman Donaldson, I have not done it recently, but last year at one point, I reviewed the authorities and powers of the SEC under the Securities Acts of the early 1930's, and my recollection is they are quite broad, and you really have very plenary authority.

Now, a considerable delegation of that authority has been exercised by the SEC with respect to the self-regulatory organizations,

but my recollection of the statute is that the ultimate decision in a sense rests with you, and it leads me to this question—whether there is any power or authority that you think you need that you do not have to enable you to enforce the policies and programs that you believe a self-regulatory organization should be pursuing—for example, the New York Stock Exchange or the Nasdaq.

Chairman DONALDSON. At this juncture, Senator, I would say that I do not see the need for new powers now. However, we are facing, as the subject matter this morning illustrates, a lot of challenges in a lot of areas. I am sure there is going to be—I should not say I am sure—I would anticipate that there probably will be pushback in certain areas that we are trying to change, and my hope is that we can convince any who might push back that we do have the authority to effect change.

Now, the New York Stock Exchange is a pretty good example of how I believe we should exercise that authority. I believe it is up to the New York Stock Exchange to straighten out its own internal governance situation, and that is probably going to require actions inside the Stock Exchange amongst the seat-holders and so forth who are willing to give their vote to have that happen. And I am not making any prejudgment on what that is, and I believe it should rest with the Stock Exchange board and right now with the new leader of that board to figure out exactly what governance structure will fit that institution. It is up to us to have oversight on that.

Senator SARBANES. I think it is important for you to send a message that this perhaps semi-slumbering lion, the SEC, having been fed a very good meal with the Congressional appropriation and having been disturbed by these things that are happening, is now up and about and prowling around, and that these various delegations and so forth need to be exercised in a way to protect the investor, and they need to get moving.

I agree with you that we have to be prudent in what we do, and this Committee last year was certainly prudent; we did not fly off the handle when we tried to deal with the legislation. We took it step-by-step. So, I am not for throwing the baby out with the bath water, but I thought Chairman Shelby was right on the mark when he said sometimes you have to give the baby a bath; I thought that was a very appropriate observation. They have really got to shape up their ship, don't you think?

Chairman DONALDSON. That is what we are trying to do, and I would like to assure you that we will use every power that we have to try to clean up whatever it is out there.

Senator SARBANES. But at the moment, you do not see a problem in terms of your power in getting the Exchange to enforce and carry out the policies and programs you think they should carry out; is that right?

Chairman DONALDSON. I do not think right now that we have any need for additional powers, but—

Senator SARBANES. Let me urge you again to take a look at this ad in *The Wall Street Journal* by the largest public employee retirement systems in the country with respect to timely access for shareholders to the board of directors. I think that is an important source of additional support the SEC could gather—it is a way of

structuring the system so that built into the system is the oversight that is desirable, so it gives the shareholders a chance to exercise that kind of overview, and I think that is very important. I know you are looking at those rules right now, as I understand it.

The final point I would like to leave with you, that I made reference to earlier, is how hard I thought the SEC staff have been working. I know they have been under enormous pressure now for more than a year; ever since the legislation was passed, they have had to go on fast-forward to move those things. Now these other issues keep arising, and they are doing studies, making recommendations, then you have to promulgate rules, then you have to review the comments, then you have to put the rules into place—all of that. So, I would urge you again to try to finally resolve this pay and benefit parity issue for your employees.

We provided in the statute that “the Commission shall seek to maintain comparability with such agencies regarding compensation and benefits.” It seems to me that clearly, you should be comparable with the other various financial regulatory agencies. I mean, you are demanding an awful lot of your people. You have a staff of dedicated people. They are facing major challenges, and I think it is important to try to resolve it. I know you have made some advances on that front, but my understanding is it is not yet completed, and I would urge you to carry on through and get that settled so that it is not a distraction—so it is not an impediment within developing a real, forward-moving *esprit de corps* at the SEC as it faces its challenges.

Chairman DONALDSON. Right. Let me thank you for your compliment to the staff of the SEC. They are doing an outstanding job, and they are working very hard at it, and they deserve every kind of support that we can give them.

We have moved ahead on pay parity, as you know, and now we are working to resolve the other issues of benefits and so forth, and we are not there yet, but we are working on it, and it is a very high priority for us.

Senator SARBANES. Thank you.

Chairman SHELBY. Mr. Chairman, I am not one to propose too much regulation on anybody, but sometimes it seems that some people cannot regulate themselves. We have seen it in the accounting profession and others. A lot of us have gone through colleges and universities where you had an honor system, and you knew to heed the honor system because there were consequences—huge consequences—among other things. Maybe the universities and colleges did not look at you every day, but you were in a sense self-regulatory to a point but not ultimately, because if you cheated in colleges and universities, you paid an awful price.

It seems that people are cheating, big time, people out of millions if not billions of dollars, and I am not sure they are paying a price for it. Part of your job, as you well know, as the top regulator over the securities market is to seek out these people who abuse the system, and I think you are off to a good start. But it is troubling again to me that we have not brought the investor confidence back to the level that we need to, and I think, what you do at the SEC will depend a lot on how fast investor confidence comes back.

People have to believe in the system, and as Senator Bunning lamented earlier, so many do not today, and for good reason. And we do not need that. It undermines everything. It undermines our economy, it undermines our country, does it not?

Chairman DONALDSON. I think that from my point of view, we will exercise our authority and responsibility as firmly and as swiftly as we possibly can.

I believe that a major step in investor confidence will come from the conviction that the SEC itself is on the job.

Senator SARBANES. Prowling around, as they say.

Chairman DONALDSON. Yes, exactly—and that we are on the job. And I agree with you that investor confidence is at a low point. Confidence in American business is at a low point—not just investor, but the American public—that has rubbed off on them. And I think we are going to do everything in our power to restore that.

Chairman SHELBY. I believe you are doing that. I think you are on the right road. I believe Senator Sarbanes and I agree that you are on the right road. It is just a tortuous road to travel.

Thank you, Mr. Chairman.

Chairman DONALDSON. Thank you.

Chairman SHELBY. The hearing is adjourned.

[Whereupon, at 11:57 a.m., the hearing was adjourned.]

[Prepared statements and response to written questions supplied for the record follows:]

PREPARED STATEMENT OF SENATOR JIM BUNNING

Thank you, Mr. Chairman, for holding this important hearing and I would like to thank Chairman Donaldson for testifying today.

The markets are doing much better since you came before this Committee for your nomination hearing. Consumer confidence is up, and the economy seems to be turning around. Job growth is still not where it should be but the strong growth in the markets is usually a precursor to economic growth. So, overall things look pretty good in our equities markets. We seem to have weathered the recession that started in 2000, the attack of September 11, the corporate scandals and 2 wars.

You started at a very difficult time for the SEC, when there was a real lack of confidence. There were a lot of problems at the SEC when you took over. Your predecessor was a very good attorney, but he lacked some political skills. I think he was also blamed for a lot of things that started before he became Chairman. But things seem to be turning around now and I believe the American people have much more confidence in the SEC.

I think seeing a few perp walks by the heads of some of our corporations who broke the law really helped in that regard.

During the question period, I will get into this a little more and ask your assessment on how the SEC is doing and where you think it can be improved. I would also like to talk a little about the hedge funds report the SEC staff put out yesterday.

Hopefully, we are coming out of this recession and the markets are leading the way. There are a lot of things that can pull us back and I trust you will remain vigilant at the SEC to make sure nothing in your area of responsibility does pull us back.

Once again, thank you Mr. Chairman for holding this hearing and thank you Chairman Donaldson for testifying today.

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

I would like to thank Chairman Shelby for holding this hearing to learn about recent initiatives to enhance investor protections in our securities markets. I am particularly pleased with the Commission's diligence in the past months in identifying and addressing challenges in the mutual fund and hedge fund industries. I look forward to hearing Chairman Donaldson's comments about the state of our securities industry, particularly as it relates to ways in which we can further protect the investor and encourage participation in our securities markets. I also anticipate hearing your thoughts on the recent recommendations of the Commission staff.

The role of the Securities and Exchange Commission has taken on even greater importance in recent years with the increasing number of Americans investing in equities. Middle class Americans invest in mutual funds to plan for retirement, to fund their children's education, or to purchase a home. More sophisticated investors like foundations, endowments, and pension plans utilize hedge funds to pursue positive returns, regardless of whether the securities markets are declining or rising. The opportunity for different levels of investors in the securities markets is integral to allowing Americans participation in the growth and development of our economy. Likewise, we must maintain the protection of investors and ensure the integrity of America's securities markets so that investment continues, and our economy remains healthy.

Thank you, Chairman Donaldson for appearing before the Committee today to discuss an issue that is essential to the health of the American economy. I look forward to your testimony and the discussion today.

PREPARED STATEMENT OF WILLIAM H. DONALDSON

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

SEPTEMBER 30, 2003

Introduction

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for inviting me to testify today on the Securities and Exchange Commission's recent initiatives to enhance investor protections in our securities markets. Since its creation in 1934, the SEC's mandate has been to protect investors and ensure the integrity of America's securities markets. That mandate has taken on even

greater importance in recent years, as increasing numbers of people have become equity investors. With more than 95 million Americans invested in mutual funds, representing approximately 54 million U.S. households, and a combined \$6.5 trillion in assets, mutual funds are a vital part of this Nation's economy. While much of the public focus over the last few years has been on events surrounding public companies, the Commission has undertaken an aggressive agenda to identify and address challenges in the mutual fund industry, an agenda that helps us to protect this vital segment of our investing public.

I would like to highlight some important actions we have recently taken to help ensure that mutual fund investors have the information they need to make their investment decisions.

Fund Advertising

Just last week, we adopted rule amendments to modernize mutual fund advertising requirements to encourage more responsible advertising. The new amendments require that fund advertisements state that investors should consider a fund's fees before investing. The amendments also require advertisements to include information about the fund's investment objectives and risks, as well as an explanation that the prospectus contains this and other important information about the fund. The amendments also strengthen the antifraud protections that apply to fund advertising and encourage fund advertisements to provide information to investors that is more balanced and informative, particularly in the area of investment performance, so that investors have access to up-to-date performance information.

In addition to rulemaking initiatives, the Commission has engaged in educational efforts to caution investors against the dangers of overemphasizing fund performance in investment decisions. These efforts included publishing an investor alert on the Commission's website that explains the importance of looking beyond past performance in making investment decisions. We also placed a "cost calculator" on our website that allows investors to compute the impact of fees and expenses of various funds on their performance and facilitates comparison of funds.

Fund of Funds

The Commission also last week proposed for public comment new rules under the Investment Company Act that would broaden the ability of one fund to acquire shares of another fund, so called "funds of funds." These funds often are used as asset allocation vehicles for a fund to gain exposure to a sector of the market by investing in another fund. This proposal also included recommended amendments that would improve the transparency of the expenses of funds that invest in other funds by requiring that the expenses of the acquired funds be aggregated and shown as an additional expense in the fee table of the acquiring funds, thereby giving investors in these funds more complete information about expenses.

Proxy Voting

In January, the Commission adopted rules that require mutual funds to disclose their proxy voting records. These rules enable fund shareholders to monitor their funds' involvement in the governance activities of portfolio companies. Under the rule, funds are required to file their proxy voting record with the Commission, which will make it publicly available through the EDGAR system. The rules also require mutual funds to disclose in their registration statements the policies and procedures they use to determine how to vote proxies related to portfolio securities. Funds have already begun complying with this requirement, and they are required to start filing their proxy voting reports next year.

Sarbanes-Oxley Requirements

In addition to Commission initiatives, mutual funds also are subject to the corporate governance requirements of the Sarbanes-Oxley Act. In each rule we have proposed and/or adopted under the Act, we have applied the corporate governance requirements to both operating companies and mutual funds, with some tailoring for the unique aspects of mutual funds. These rules include the rules on CEO and CFO certification requirements, code of ethics requirements, disclosure of audit committee financial experts, auditor independence and, most recently, audit committee listing standards. This last rule, adopted as part of a broader rulemaking regarding audit committee standards, applies only to listed companies and therefore includes only exchange-traded funds, or listed closed-end funds. The rule directs the exchanges and Nasdaq to prohibit the listing of any security of an issuer in violation of new standards of audit committee responsibility and independence.

Future Mutual Fund Activity

In addition to these rulemaking activities, we have a number of other initiatives in the pipeline.

Breakpoint Disclosure

We anticipate taking action to improve the disclosure of breakpoint discounts, which are discounts on front-end sales loads based on the aggregate amount of purchases of a fund's shares. Funds that offer breakpoint discounts must disclose the breakpoints and related procedures in their offering documents. Brokers that sell shares of funds that offer discounts have an obligation to help ensure that shareholders are receiving those discounts. Late last year, however, the staffs of the NASD and the SEC identified concerns regarding breakpoints. The staffs discovered that many fund investors were not receiving the appropriate discounts. The SEC and NASD took swift action—reminding funds and brokers of their obligations, requiring brokers to assess the extent of the problem, and directing the industry to convene a task force to address the problem. In July, a Joint NASD/Industry Report on Breakpoints was released containing recommendations to assure that investors receive available discounts on mutual fund shares subject to front-end sales loads.

The Breakpoint Report contains a number of recommendations to limit the problems associated with the provision of breakpoint discounts, as well as to improve the disclosure of breakpoint opportunities. I have directed the staff to draft a rule for Commission consideration consistent with these recommendations to help ensure that investors receive the appropriate discounts in the future. In addition, the NASD and SEC staffs continue to monitor and quantify the problem and have directed firms that have failed to provide the appropriate breakpoints in the past to compensate and make whole any affected investor. We and the NASD will continue to investigate, and where warranted, will bring enforcement actions in this area.

Shareholder Report Disclosure of Operating Expenses

We have also proposed additional disclosure to increase investors' understanding of the expenses they incur when investing in a mutual fund. Under this proposal, mutual funds would be required to disclose in their shareholder reports the "dollar amount" of fund expenses paid by shareholders on a prescribed investment amount—based on both the fund's actual expenses and return for the period, as well as the fund's actual expenses for the period based on an assumed return of 5 percent per year. By using both these measures, the dollar disclosure would enable investors to determine the amount of fees they paid on an ongoing basis, as well to compare the amount of fees charged by other funds. The goal of the proposal is to educate investors and to encourage cost competition among funds. This proposal also would require more frequent disclosure of portfolio holdings (for example, quarterly rather than semi-annually) to enhance investor understanding of the securities in the fund's portfolio so investors can make better asset allocation decisions. I expect the Commission to consider adopting these new requirements in the near future.

Highlighting Broker Incentives and Conflicts of Interest

Another area we are looking at is how to increase investor understanding of the incentives and conflicts that broker-dealers have in offering mutual fund shares to investors. Initiatives we are considering in this area include a comprehensive revision of mutual fund confirmation form requirements. I envision a revised confirmation would include information about revenue sharing arrangements, incentives for selling in-house funds and other inducements for brokers to sell fund shares that may not be immediately transparent to fund investors.

In addition to its disclosure initiatives, the Commission has focused its rulemaking efforts on fund governance and internal compliance issues. Although we have focused on these issues for some time, recent events in the mutual fund industry underscore the importance of funds' maintaining appropriate measures to ensure their adherence to both the letter and spirit of the Federal securities laws.

Mutual Fund Compliance Rule

In February, the Commission published for comment proposed rules aimed at ensuring better compliance with regulations governing mutual funds. These rules would mandate that funds and investment advisers maintain comprehensive compliance policies, and procedures reasonably designed to prevent violations of the Federal securities laws. The rules also require that funds designate a chief compliance officer. While the proposal does not enumerate specific elements funds must include in their compliance programs—as funds are too varied in their operations for us to impose a single list of required elements—it is designed to ensure that policies and procedures are in place to lessen the likelihood of securities law violations and detect any violations that do occur.

Consequently, we would expect funds to have policies and procedures to address pricing of portfolio securities and fund shares; processing of fund shares on a timely basis; portfolio management processes, including allocation of investment opportunities among clients; the accuracy of disclosures made to investors in fund prospectuses (disclosures that would include representations regarding market timing policies and procedures); and processes to value client holdings and assess fees based on those valuations.

While we expect that these rules would help protect investors by improving day-to-day compliance with the Federal securities laws, the rules should also increase the efficiency and effectiveness of the Commission's mutual fund examination program. Our oversight is predicated on the assumption that those who manage mutual funds have procedures to comply with the law. While the proposal would codify the prudent compliance practices already followed by most fund complexes, in some cases mutual funds have few compliance controls in place or have gaps in their controls. These proposals are intended to raise the standard of compliance among all mutual funds, and I expect the Commission will consider adoption of these requirements later this fall.

Director Nomination Rules

We have also included mutual funds in initiatives to increase shareholder participation in the director nomination process. Last month, we proposed rule changes to strengthen disclosure requirements relating to the nomination of directors and shareholder communications with directors. The proposals apply to both operating companies and mutual funds.

The proposals would require a fund to disclose additional information regarding its process of nominating directors, including whether members of the nominating committee are "interested persons" of the fund; a fund's process for identifying and evaluating candidates; whether a fund considers candidates for director nominees put forward by shareholders; and whether a fund has rejected candidates put forward by large long-term shareholders or groups of shareholders. The proposals would also require a fund to disclose information regarding shareholder communications with directors, including whether the fund has a process for such communications and the procedures shareholders should follow; whether the communications are screened; and whether material actions have been taken as a result of shareholder communications in the last fiscal year.

The proposed rules implement the first part of the recommendations of a Commission Staff Report issued on July 15, 2003, regarding improvements to the proxy process. The enhanced disclosure provided by the proposal should benefit fund shareholders by improving the transparency of the nominating process and board operations, as well as increasing shareholders' understanding of the funds in which they invest. The Staff Report also recommends under certain circumstances that major long-term shareholders, or groups of shareholders, be provided access to proxy materials to nominate directors where there are objective criteria indicating that shareholders may not have had adequate input in the proxy process. I expect that we will propose rules to implement this recommendation shortly, and that they will apply with equal force to mutual funds.

Updates On Other Issues

I understand the Committee is interested in getting an update on a few other issues for today's hearing, so let me briefly bring you up to speed in those areas.

Hedge Fund Report

Since June of last year, the SEC staff has conducted a comprehensive study focusing on the investor protection implications of the significant growth of hedge funds in recent years. As part of that study, the staff reviewed documents from 65 hedge fund advisers managing more than 650 different hedge funds with more than \$160 billion of assets. The staff also visited hedge fund advisers and prime brokers and conducted a series of examinations of registered funds of hedge funds. Finally, the staff benefited from views expressed at a highly successful two-day Roundtable we held at the Commission, during which a variety of experts discussed key aspects of hedge fund operations, as well as the views contained in approximately 80 public letters we received commenting on the roundtable discussion and hedge fund issues.

When I testified before you in April, the study was still at the fact-gathering stage and the staff had not reached any conclusions. Just yesterday, however, the Commission released a staff report (the Report) that outlines the staff's factual findings, identifies concerns and recommends certain regulatory and other actions to improve the current system of hedge fund regulation and oversight.

Let me emphasize at this time that this is a staff report. The next step is for the Commission to consider these recommendations to determine how we may wish to

proceed. Any recommendation that the Commission determines to act upon will require us to go through the appropriate administrative process, so rest assured that investors, market participants, and other interested persons will have ample opportunity to comment upon any of the recommendations that the Commission chooses to pursue. However, I would like to highlight for you today some of the staff's findings and its primary recommendation.

In its Report, the staff identifies a number of areas of concern regarding hedge funds: (i) lack of Commission information about hedge funds and their advisers' activities; (ii) lack of prescribed and uniform disclosure by hedge fund advisers; (iii) valuation and other conflict of interest issues; (iv) the potential for increased investment by less sophisticated investors, directly or indirectly, in hedge funds; and (v) despite the relatively low absolute number, an increase in the number of enforcement actions regarding hedge fund advisers. Many of these concerns arise from the unregulated status of hedge funds, which generally allows them to operate without Commission oversight. Consequently, the primary recommendation of the staff is that the Commission should consider revising its rules to require that hedge fund advisers register under the Advisers Act. While I am looking forward to studying the staff's Report and the recommendations contained in it before drawing any conclusions, I will say, as I have before, that I believe that the Commission needs to have a means of examining hedge funds and how they operate. Speaking only for myself, I believe that registration of hedge fund advisers would accomplish this.

Canary Investigation

While I am on the topic of hedge funds, let me update you about our involvement in recent allegations regarding a hedge fund's practices in late trading mutual funds, as well as questions concerning funds' permitting market timers to arbitrage the funds, which underscore the importance of the SEC's ongoing review of the hedge fund and mutual fund industries. Both of these activities have the potential to harm long-term investors in mutual funds.

The conduct alleged in the case involving Canary Capital, an unregistered hedge fund, is reprehensible and in violation of fiduciary principles. We have put in motion an action plan to vigorously investigate this matter, assess the scope of the problem and hold any wrongdoers accountable, and we will do so in close coordination with State regulators.

Already, we have filed a civil action against Theodore Sihpol, a salesperson at Bank of America Securities, who was Canary Capital's primary contact at Bank of America. Our examiners and enforcement staff are actively investigating this matter, not only the extent to which the allegations in this particular case are true, but also whether this conduct occurs at other firms in the securities industry. I want to emphasize that we will aggressively pursue those who have injured investors as a result of illegal late-trading and/or market-timing activity and, where possible, to seek recompense for these investors in connection with mutual fund transactions.

Additionally, the Commission's staff has sent detailed information requests to registered prime brokerage firms, other large broker-dealers, transfer agents, and the 80 largest mutual fund complexes in the country seeking information on their policies and practices relating to market timing and late trading. Specifically, we are using our examination authority to obtain information from mutual funds and broker-dealers regarding their pricing of mutual fund orders and adherence to their stated policies regarding market timing. We also have sought information from mutual funds susceptible to market timing regarding their use of fair value pricing procedures to combat this type of activity.

More broadly, I believe that the industry must take steps to review its own conduct. To that end, I sent letters to major trade associations for the mutual fund and broker-dealer industries asking them to notify their members to review and reassess their procedures relating to the handling of mutual fund investments in accordance with applicable law.

While our enforcement efforts are a key tool in protecting the Nation's investors, another critical tool is regulation to minimize the potential for abuses to occur in the first place. We will consider what we learn from the investigation to determine whether we should pursue additional regulatory measures to thwart this type of activity. Specifically, our staff is studying whether we need to take additional steps to (1) pursue measures to prevent the circumvention of forward-pricing requirements for fund shares and market timing restrictions, (2) require funds to have written policies and procedures to address short-term trading in their shares, (3) require improved disclosure regarding market timing procedures, (4) provide funds with additional tools to deter market timing activity, and (5) address concerns related to the selective disclosure of fund portfolio information.

NYSE / Corporate Governance

I would now like to turn to an issue that is important both from a regulatory standpoint and from the standpoint of the investing public: the critical need for sound governance practices by self-regulatory organizations. I believe that self-regulatory organizations should be exemplars of good governance. At a minimum, SRO's should demand of themselves the same high standards of governance that the New York Stock Exchange and Nasdaq proposed for their listed issuers in the wake of several widely publicized corporate scandals. To further that goal, this past March I directed each self-regulatory organization to undertake a review of its own governance practices.

Since then, disclosure of the pay package awarded to the former Chairman of the New York Stock Exchange has heightened the scrutiny that the Commission, the securities industry, the investing public, and the media are paying to exchange governance standards that reflect the highest commitment to independent and transparent decisionmaking. Prior to the current controversy, the NYSE and a few other self-regulatory organizations instituted special governance committees to further study how their structures and processes might be improved. I applaud these efforts but I believe that more remains to be done. I have assurances that the NYSE's new interim Chairman, John Reed, will reexamine these governance issues in more depth. I look forward to working with Mr. Reed on this important initiative.

Our securities markets are the strongest in the world. They have earned this position not only because they have the largest issuers, the greatest depth and liquidity, the most capital, and efficient execution systems—but they also have a high degree of investor confidence. I intend to assure that investors can have a strong sense of trust and confidence in our exchanges. To this end, the Commission and its staff will be working diligently with the SRO's to craft a regulatory environment that sets a high bar for sound and rigorous governance practices.

Global Settlement

Finally, the Committee requested an update, since my testimony on May 7, on the status of the research analyst global settlement, the SEC's portion of which was filed with a Federal court on April 28, 2003. As described in the Commission's May 7 testimony, the global settlement would impose significant monetary relief, require the firms to make structural reforms to their research and investment banking operations, require the firms to provide customers with independent third-party research, and establish an investor education fund.

Since the filing of the proposed settlement agreement with the Federal court, U.S. District Court Judge William H. Pauley, III has issued a series of orders requesting that the parties—both the Commission and the participating firms—submit additional information to the Court relating to the terms of the settlement. Those orders, dated June 2 and July 3, address a range of issues. Among the issues addressed were:

- the implications for the proposed Federal settlement should any State determine not to settle with a firm, and whether there is a timeframe in which each state must act on the proposed State settlements;
- the allocation of the settlement payments between disgorgement and penalties, and whether any firms intend to seek Federal tax deductions or third-party indemnification for settlement payments;
- the operations of the Distribution and Investor Education Funds, such as the identity of potentially relevant securities and time periods, the number of shares of each potentially relevant security purchased by each firms' customers, the total dollar volume of such purchases, and whether the Investor Education Fund should have audit procedures.

The Commission and the firms filed responses to the Court's orders, and the proposed global settlement remains pending before the Court. Nevertheless, the Commission staff believes that, in anticipation of the Court's approval of the settlement, firms are moving forward with preparations to implement the settlement requirements. Moreover, the staff of the Commission will respond to any future inquiries from the Court, and will work to have the global settlement implemented as soon as possible.

Conclusion

Thank you again for inviting me to speak on behalf of the Commission and the investing public. We, at the Commission, take our responsibility of protecting our Nation's investors very seriously. I welcome the opportunity to share our current initiatives with you, and I would be pleased to answer any questions that you may have.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SARBANES
FROM WILLIAM H. DONALDSON**

Q.1. Some witnesses in testimony to the Banking Committee have recommended that public companies boards of directors have a majority of independent directors and that their nomination and compensation committees be composed totally of independent directors. The New York Stock Exchange and the National Association of Securities Dealers have proposed corporate governance reforms that would require listed companies to have a majority of independent directors on their boards of directors and to have all independent directors on their nomination and compensation committees, subject to an exception for controlled companies in which a group has voting control. The exception would apply both where a group owns a majority of the equity, and where a group owns a minority of the equity position. The Federal securities laws require the Commission to approve only rules of an SRO that it finds are not designed to permit unfair discrimination between issuers. What is the rationale for requiring some issuers to establish minimum independence qualifications for directors, but not others?

A.1. In the NYSE and Nasdaq proposals, a “controlled company”—defined as a company of which more than 50 percent of the voting power is held by an individual, a group, or another company—was excepted from the requirement of having a majority of independent directors on its board and having nominations and compensation determined exclusively by independent directors.

The rationale for this exception is that majority shareholders, including parent companies, have a right to select directors and control certain key decisions by virtue of their ownership rights. Any company in which such a majority prevailed would be entitled to this exception.

In addition, the NYSE stated in its summary of comments on the recommendations of its committee that developed its corporate governance proposals that more than half of commenting companies noted that the majority independent board requirement would create insuperable difficulties for companies controlled by a shareholder or parent company.

It is also important to note that through the associated disclosure requirements of these proposals, the company would be required to put investors on notice that it is using the controlled company exception. In addition, a controlled company would not be exempt from—and would still need to comply with—all the audit committee requirements mandated by the Sarbanes-Oxley Act, including the requirement to have an audit committee comprised solely of independent directors.

Q.2. An article in the September 23, 2003, *The New York Times* entitled “Worry Over a New Conflict for Accounting Firms,” indicates that auditors are citing language in the Commission’s releases implementing Section 404 of the Sarbanes-Oxley Act to justify providing services in connection with the internal controls of public company clients, despite the fact that such advice may place auditors in the position of auditing their own work, in light of the auditor attestation called for by Section 404. The same point was made

in the testimony before the Committee on September 23 by Edward Nusbaum, the CEO of Grant Thornton.

The Commission's release on internal controls indicates that:

Because the auditor is required to attest to management's assessment of internal control over financial reporting, management and the company's independent auditors will need to coordinate their processes of documenting and testing the internal controls over financial reporting. Nos. 33-8238; 34-47986; IC-26068, Part II.B.3.b (Auditor Independence).

The Commission's auditor independence release states that

"[an] accountant would not be precluded [by the prohibition on '[d]esigning, implementing, or operating systems affecting the financial statements']" from making recommendations on internal control matters to management or other service providers in conjunction *with the design and installation of a system by another service provider*. Release No. 33-8183; 34-47265; 35-27642; IC-25915; IA-2103, FR-68, Part II.B.2 (Financial Systems Design)[Emphasis supplied.]

How do you respond to the criticism that the Commission's rules can allow an auditor to attest to its own work insofar as internal control systems are concerned? What is the line between an auditors' "assisting in documenting internal controls" and its "designing and installing" such a system? Is the Commission considering clarifying the distinction between the two activities, or engaging in fact finding about the services accounting firms are offering to their audit clients in connection with the new internal controls rules?

A.2. The Commission's rules prohibit an auditor from auditing his/her own work, acting as a member of management and, more specifically, performing the internal audit function, through an outsourcing arrangement, for an audit client that files financial statements with the Commission. The auditor of a public company's financial statements, therefore, shouldn't design or implement that company's internal controls over the financial reporting process.

During an audit of a company's financial statements, however, an auditor must obtain an understanding of the company's internal control system. Investors benefit if the auditor informs management of any deficiencies in the controls that are noted during the audit and is able to recommend improvements in those controls. In fact, auditing standards require that such communications occur. Management, however, must decide whether or how to implement those recommendations.

As noted in the question above, Section 404 of the Sarbanes-Oxley Act requires that managements now assess and report on the effectiveness of the company's internal controls and that the auditor report on management's assessment. In preparing for the initial operation of Section 404, managements of many companies have asked the auditors of their financial statements to assist company employees by, among other things, providing templates to be used in documenting controls and finding areas where management might want to improve the controls. Auditors generally may provide these types of assistance *provided* management makes all decisions regarding the design, implementation, and operation of the company's internal controls. For example, an auditor's independence would be impaired if the auditor decided what tests management should perform on the internal controls, chose the samples or even the size of the samples of transactions to be tested, or provided management with software that directed a conclusion about the effectiveness of the company's internal controls.

The SEC staff has discussed this issue with several accounting firms and has cautioned those firms against assuming a management role or taking any action that would lead to the auditor having a vested interest in the design, selection, or operation of the internal control system.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR BAYH AND
SENATOR MILLER FROM WILLIAM H. DONALDSON**

Q.1. As you may know, I have been following the Nasdaq exchange registration application with interest for several years. At our September 30 hearing you stated that Nasdaq does not qualify for exchange registration because it does not provide opportunities for order interaction and price improvement. This statement surprised me. As I understand it, in 1998, the Commission stated that “Nasdaq performs what today is generally understood to be the functions commonly performed by a stock exchange,” and that “Nasdaq’s use of established, nondiscretionary methods bring it within the revised interpretation of ‘exchange’ in Rule 3b-1.”¹ Please provide me with the analysis that now leads you to conclude that Nasdaq does not qualify as an exchange and why diversion from your predecessors’ conclusion is warranted.

A.1. Prior to the adoption of Regulation ATS in December 1998, the Commission had defined the term “exchange” somewhat narrowly as a system that utilized the capital of specialists in a marketplace “generally understood” to be an exchange. Through Regulation ATS, the Commission established a framework that would allow an alternative trading system (ATS) to choose whether to be a market participant and register as a broker-dealer, or to be a separate market and register as a “national securities exchange.” The primary goal of the new regulation was to integrate ATS’s into the National Market System (NMS). The Commission’s objective of incorporating ATS’s into the NMS was accomplished through an expansion of the definition of exchange found in Securities Exchange Act Rule 3b-16. The expanded definition covered most ATS’s, but exempted ATS’s from national securities exchange registration if they chose to register pursuant to Regulation ATS.

As you accurately note, the expanded definition of exchange required the Commission to address the definition’s applicability to Nasdaq, a subsidiary of the only registered “national securities association.” Specifically, the Commission stated in the Regulation ATS adopting release that Nasdaq did, in fact, fit within the new expanded definition of exchange and that it could apply for registration as a national securities exchange. Moreover, the release stated that the requirements for registration as a national securities association were “virtually identical” to those of a national securities exchange. Notwithstanding the adopting release language, the Commission has always been wary of the critical distinction between the operation of national securities exchanges and the Nasdaq interdealer market. Specifically, Nasdaq does not offer intramarket price priority, while national securities exchanges re-

¹ Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844, 70852 (December 12, 1998). *See also*, Securities Exchange Act Release No. 44201 (April 18, 2001) at note 22 (The Commission has found that Nasdaq falls within the definition of “exchange” under Section 3(a)(1) of the Act.).

quire a degree of order interaction and potential price improvement beyond what is available at the national best bid and offer (NBBO).

Thus, the Commission is currently reflecting upon intramarket price priority in the context of Nasdaq's pending application to become a national securities exchange. The Commission is particularly concerned that, if Nasdaq is permitted to operate as a national securities exchange without intramarket price priority, other national securities exchanges will surely follow. This raises the question of how important is intramarket price priority and is it in investors' interests for it to no longer be offered by national securities exchanges. Clearly, these are key market structure issues that have implications well beyond whether Nasdaq's registration application is granted.

Q.2. You also stated concern about public ownership of an exchange and what kinds of protections can be built into such a structure. I understand that at the request of the Commission, Nasdaq prohibits any one shareholder from voting more than 5 percent of the shares outstanding, regardless of the percentage of shares owned by a shareholder. In addition, the SEC reviews and approves all changes to Nasdaq's articles of incorporation and bylaws, which would give the SEC the ability to review any changes to Nasdaq's corporate structure. Aren't a number of exchanges around the world (including the Chicago Mercantile Exchange) publicly owned public companies? I am not aware of any problems from this structure, is the SEC? As I understand it, the key value of public ownership is transparency and accountability since public companies are subject to all the disclosure rules and things are not secret and clubby. They must file quarterly disclosure reports, detailed information on executive compensation and their business, and audited financials so all the world, including SEC can monitor what they are doing.

A.2. You are correct that there has been a recent global trend toward the demutualization of financial exchanges. The Chicago Mercantile Exchange completed its demutualization and became the first publicly traded U.S. financial exchange in December 2002, when its shares began trading on the New York Stock Exchange, Inc. (NYSE). In addition, the National Association of Securities Dealers, Inc. (NASD) is in the process of demutualizing the Nasdaq Stock Market, Inc. (Nasdaq) and has applied to register it as a national securities exchange. The NYSE announced its desire to demutualize in 1999, but has not made significant progress in that regard to date. A number of overseas exchanges have also moved toward demutualization, including the Stockholm Stock Exchange, the Amsterdam Stock Exchange, the London Stock Exchange, and the Deutsche Bourse.

You are also correct that the periodic reporting requirements, imposed upon public companies, benefit investors in a number of ways, including by making public companies' financial conditions and corporate governance practices transparent. Moreover, Nasdaq has argued that it should be permitted to offer its shares to the public in order to compete effectively. Specifically, Nasdaq has asserted that going public would unlock its inherent value and provide it with capital for use in competing with the nimble electronic

communications networks (ECN's). Nasdaq believes that demutualization and registration as a national securities exchange will help it compete by streamlining its corporate decisionmaking.

While benefits may be gained from the demutualization of financial exchanges and from the public trading of exchange shares, these issues raise potential problems. For instance, a commercial self-regulatory organization (SRO), engaged in developing its business and competing with other SRO's, may not be able to police its members effectively. Some argue that inherent conflicts of interest exist in the demutualized exchange environment between the SRO's goal of serving profit-driven shareholders and the SRO's obligation to act as a front line enforcer of the Federal securities laws. These conflicts could present themselves in a variety of ways, including discrimination through the imposition of disciplinary sanctions on members, unfairness in what services are offered to different types of members, and discriminatory fee setting. Moreover, profit-driven SRO's may be tempted to maximize shareholder profit, by making overly aggressive reductions in self-regulatory spending. In addition, a market, like Nasdaq, could be confronted with the difficult decision of either submitting to the listing standards of another market, like the NYSE, or listing shares on its own market. If Nasdaq selected the latter option, it would find itself in the tenuous position of being regulated by its own listing standards regulatory staff. Thus, the Commission is in the process of considering whether the traditional nonprofit SRO model is still effective, but is wary of the potential problems that can result from permitting exchanges to go forward as for-profit entities.

Q.3. You also stated that Nasdaq had “backed into” its status as a for-profit company. Is it not true that the Commission was involved and engaged in every step of that process and the plans were approved by the Commission? What did you mean by “backed into?”

A.3. During my testimony before the Subcommittee, I indicated that Nasdaq had “backed into” its current status as a for-profit entity. Your inquiry as to how I could characterize Nasdaq's actions as such when the Commission has overseen the actions taken by Nasdaq is well taken. By way of background, the NASD was completely reorganized in 1996 in the aftermath of a Department of Justice and Commission investigation into anticompetitive practices by OTC market makers. This reorganization resulted in the creation of a parent holding company and two operating subsidiaries—Nasdaq and NASD Regulation, Inc. Encouraged, in part, by the lofty market valuations of public companies in the late 1990's and the global trend of demutualization, NASD explored the possibility of demutualizing Nasdaq, registering it as a national securities exchange, and raising capital for Nasdaq through a public offering.

In that regard, on April 14, 2000 the membership of the NASD voted overwhelmingly to turn Nasdaq into a for-profit company and alter its ownership structure. This ongoing transformation is being accomplished in two stages. In the first stage, up to 49 percent of Nasdaq's common stock was offered in a private placement to NASD members, Nasdaq issuers, institutional investors, and stra-

tegic partners. After a further sale of Nasdaq stock in the second phase and the triggering of certain warrants, NASD will own a minority stake of Nasdaq, but will retain significant voting rights held in a voting trust until such time as Nasdaq is registered as a national securities exchange. NASD has stated that the purpose of the demutualization of Nasdaq is to permit the NASD to focus more intently on its primary task of member regulation, to streamline Nasdaq's corporate decisionmaking process, and to unlock Nasdaq's inherent value through a public offering.

As recent events have indicated, potential conflicts of interest may arise when there are insufficient barriers between regulatory staff and commercial pressures. While the Commission generally has supported the NASD's efforts to insulate its operations from commercial pressures by demutualizing Nasdaq, there are, as outlined above, very serious issues raised by Nasdaq being a publicly traded national securities exchange.

Q.4. Mr. Chairman, the Commission held public hearings on market structure issues earlier this year and part of last year, I think. What is going to be the outcome of those public hearings and what is the time frame for it?

A.4. As you correctly note, the Commission held public hearings in late 2002 to address a wide variety of complex market structure issues, including the quoting and trading in subpenny increments, the fair and efficient access among different types of market centers, the appropriateness and level of access charges between market participants, the protection of prices across different types of markets and its relationship with best execution, the sale and distribution of revenue generated by market data, and the criteria for registration as a national securities exchange. The overriding theme derived from the hearings was that the principle of a centralized National Market System, as set forth in Section 11A of the Securities Exchange Act of 1934, remains valid today and is worth preserving with some modernization. Having considered industry views, the Commission is now in a position to take action. In that regard, we are crafting Commission proposals for rulemaking that will be published for public comment in the *Federal Register*. We anticipate that proposals on access to markets (including access fees and the trade through rule) and market data will be published in early 2004. Thereafter, we would expect to issue proposals addressing other market structure issues, including those relating to the self-regulatory system and the criteria for registration as a national securities exchange.

**RESPONSE TO A WRITTEN QUESTION OF SENATOR ALLARD
FROM WILLIAM H. DONALDSON**

Q.1. The Investment Company Act gives the SEC explicit authority to sue investment company management for charging excessive fees and imposing a fiduciary obligation on the adviser with relation to receiving these fees. How many times has the SEC used this statutory authority?

A.1. Section 36(b) of the Investment Company Act of 1940 (Investment Company Act) authorizes the Commission to institute enforcement actions against investment advisers for charging in-

vestment companies excessive fees. Section 36(b) imposes on an investment adviser to an investment company a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by the investment company or its shareholders to the adviser or its affiliated persons. The Commission and investment company shareholders may institute an action in Federal district court against the investment company's investment adviser and its affiliated persons "for breach of fiduciary duty in respect of such compensation or payments" paid by the investment company or its shareholders.¹ Congress adopted Section 36(b) in 1970 in response to concerns that investment company advisory fees were not subject to the normal competitive pressures prevalent in other areas of commerce because investment companies typically are organized and operated by their investment advisers.²

The Commission has instituted two enforcement actions under Section 36(b) against investment advisers, among others, for breach of their fiduciary duties with respect to the receipt of compensation. In *SEC v. American Birthright Trust Management Co.*, the Commission alleged that the compensation paid by an investment company to its investment adviser for advisory and related services was excessive in light of the services actually performed by the investment adviser, and that most of the advisory services provided to the investment company were actually provided by a subadviser retained by the adviser.³ In addition, in *SEC v. The Fundpack, Inc.*, the Commission alleged that an investment adviser and its affiliates breached their fiduciary duty under Section 36(b) by operating investment companies in a manner designed to generate benefits for themselves at the direct expense of the investment companies and their shareholders.⁴

Investment company shareholders have instituted numerous actions under Section 36(b). The seminal case under Section 36(b) is *Gartenberg v. Merrill Lynch Asset Management, Inc.*,⁵ in which the court interpreted Section 36(b) as involving an evaluation of whether the compensation that is paid to an investment adviser is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."⁶ The court identified several factors (commonly referred to as the "Gartenberg factors") that should be evaluated when determining whether a breach of fiduciary duty has occurred.⁷ Courts generally have evaluated subsequent Section 36(b) actions using the Gartenberg factors.

¹Section 36(b) of the Investment Company Act. An investment adviser's duty under Section 36(b) relates to all of the compensation that the adviser and its affiliated persons receive from the investment company, including any distribution payments such as Rule 12b-1 fees.

²See SEC, Report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 10-12, 126-27, 130-32 (1966). Section 36(b) was adopted in response to Congress's recognition that the Investment Company Act, as originally enacted, "did not provide any mechanism by which the fairness of management contracts could be tested in court." Investment Company Amendments Act of 1970, S. Rep. No. 91-184, 91st Cong., 1st Sess. 5 (1969).

³See *SEC v. American Birthright Trust Management Co.*, Lit. Rel. No. 9266 (December 30, 1980).

⁴See *SEC v. The Fundpack, Inc.*, et al., Lit. Rel. No. 8698 (March 22, 1979).

⁵694 F.2d 923 (2d Cir. 1982).

⁶*Id.* at 928.

⁷These factors generally include: (1) the nature and quality of all of the services provided by the investment adviser (either directly or through affiliates), including the performance of the investment company; (2) the investment adviser's cost in providing the services and the profit-

To date, investment company shareholders have had mixed success in litigating Section 36(b) actions. In certain Section 36(b) cases, the investment advisers to investment companies have chosen to settle the litigation, and some of these settlements have resulted in lower investment company advisory fees. In the remainder of the cases, however, the investment advisers have prevailed. The Commission staff monitors these actions.

The Commission's staff continues to evaluate potential actions under Section 36(b) according to the standards set forth in *Gartenberg*. The staff typically examines the minutes of investment company board of directors' meetings to determine what factors the board considered in evaluating the company's advisory fees. In addition to examining board minutes, the staff also considers any other information relied upon by directors in assessing the investment company's advisory fees.⁸

**RESPONSE TO A WRITTEN QUESTION OF SENATOR CHAFEE
FROM WILLIAM H. DONALDSON**

Q.1. While the Sarbanes-Oxley Act and other Federal laws make it clear that electronic data and other information must be preserved at the initiation of a formal investigation, it is not clear what steps a company should take to preserve and protect electronic data when it becomes aware of an informal SEC investigation or inquiry.

Electronic data, including e-mail, is often routinely deleted in order to manage the large volume of information generated in the normal course of business. As a result, there is the potential that critical evidence is being routinely deleted between the time a company becomes aware of an informal investigation and the notification of a formal investigation.

Are you concerned that such data loss is having a negative impact on the SEC's ability to enforce the Sarbanes-Oxley Act? If so, should the Commission study the issue to determine whether its enforcement function would be improved by developing specific guidelines regarding what electronic data must be preserved when a company becomes aware that it is the subject of an informal investigation?

A.1. E-mail and other electronic records are important to SEC investigations of potential wrongdoing by securities firms, public companies, accounting firms, individuals, and others. The Sarbanes-Oxley Act and other laws and rules impose record retention and preservation requirements on certain entities or persons in various circumstances. Indeed, some of these requirements are ap-

ability of the investment company to the adviser; (3) the extent to which the investment adviser realizes economies of scale as the fund grows larger; (4) the "fall-out" benefits that accrue to the investment adviser and its affiliates as a result of the adviser's relationship with the investment company (for example, soft dollar benefits); (5) the performance and expenses of comparable investment companies; (6) the expertise of the independent directors, whether they are fully informed about all facts bearing on the investment adviser's service and fee, and the extent of care and conscientiousness with which they perform their duties; and (7) where relevant, the volume of transaction orders that must be processed by the investment adviser.

⁸ Under Section 15(c) of the Investment Company Act, it is the duty of directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, any information that may reasonably be necessary for the directors to evaluate the terms of any investment advisory contract with the investment company.

plicable even prior to the initiation of a formal Commission investigation.

In the case of broker-dealers, for instance, Rule 17a-4(b)(4) under the Securities Exchange Act of 1934 requires that broker-dealers retain, among other records, “originals of all communications received and copies of all communications sent (and any approvals thereof) by the member, broker, or dealer (including interoffice memoranda and communications) relating to [their] business as such” The Commission interprets this rule as covering electronic records, including e-mail. The required retention period is “not less than 3 years,” and the obligation to preserve records applies whether or not the Commission is conducting an investigation of the broker-dealer or its employees. Violations of this rule have resulted in enforcement action. For example, in December 2002, the SEC, New York Stock Exchange, and NASD filed joint actions against five broker-dealers for violations of record-keeping requirements concerning e-mail communications. The firms consented to the imposition of fines totaling \$8.25 million, along with a requirement to review their procedures to ensure compliance with recordkeeping statutes and rules. The firms—Deutsche Bank Securities Inc., Goldman, Sachs & Co., Morgan Stanley & Co. Incorporated, Salomon Smith Barney Inc., and U.S. Bancorp Piper Jaffray Inc.—agreed to be censured and to pay fines of \$1.65 million per firm to the U.S. Treasury, NYSE, and NASD. Section 802 of the Sarbanes-Oxley Act imposes a similar requirement on public company auditors to routinely retain audit or review workpapers. The Commission’s rules promulgated pursuant to Section 802 specify that accounting firms must retain for 7 years certain records relevant to their audits and reviews of issuers’ financial statements. The records to be retained include an accounting firm’s workpapers and certain other documents that contain conclusions, opinions, analyses, or financial data related to the audit or review. Compliance is required for audits and reviews completed on or after October 31, 2003. This preservation requirement applies whether or not the Commission is conducting an investigation.

Section 802 of the Sarbanes-Oxley Act also includes a provision addressing the handling of records in Federal investigations and bankruptcy. Specifically, the provision makes it a felony for a person to destroy or create evidence with the intent to obstruct an investigation or matter that is within the jurisdiction of any Federal agency.¹ In one of the first uses of Section 802, on September 25, 2003, the U.S. Attorney’s Office for the Northern District of California, the Federal Bureau of Investigation, and the SEC jointly announced that a former Ernst & Young partner who allegedly altered and destroyed audit working papers, was arrested on criminal charges for obstructing investigations by both the Office of the Comptroller of the Currency and the SEC. Also in connection with the document destruction, a former Ernst & Young senior manager pled guilty to one count of obstructing the examination of a financial institution. The SEC instituted administrative proceedings in

¹ The Sarbanes-Oxley Act also includes a provision making it a felony punishable by a fine and up to 20 years in prison to corruptly alter, destroy, mutilate, or conceal a record or document, or attempt to do so, with the intent to impair the object’s availability for use in an official proceeding. Sarbanes-Oxley Act, Section 1102, codified at 18 U.S.C. 1512(c).

which the Division of Enforcement alleged that the partner and a former audit manager engaged in unethical and improper professional conduct in violation of SEC Rule of Practice 102(e) as a result of their alteration and destruction of documents. The SEC also instituted a settled administrative proceeding against the former senior manager for his role in the document destruction.²

The language of Section 802 also covers acts of destruction either in contemplation of or in relation to matters within the jurisdiction of a Federal agency. The author of this provision, Senator Patrick Leahy, stated:

This statute is specifically meant not to include any technical requirement, which some courts have read into other obstruction of justice statutes, to tie the obstructive conduct to a pending or imminent proceeding or matter by intent or otherwise. It is also sufficient that the act is done “in contemplation” of or in relation to a matter or investigation. *It is also meant to do away with the distinction, which some courts have read into obstruction statutes, between court proceedings, investigations, regulatory or administrative proceedings (whether formal or not), and less formal government inquiries, regardless of their title.* Destroying or falsifying documents to obstruct any of these types of matters or investigations, which in fact are proved to be within the jurisdiction of any Federal agency are covered by the statute. [emphasis added]

A recent ruling in a criminal case, *U.S. v. Kim*, is illustrative of the concerns expressed by Senator Leahy about other obstruction statutes. Kim was charged with making a false statement to the SEC staff that were investigating possible insider trading by Kim. The false statement was made on September 12, 1999 while the staff had open a preliminary inquiry. On September 23, 11 days after Kim made his statement to the staff, the staff closed the preliminary inquiry and opened a formal investigation. A jury subsequently convicted Kim of making a false statement to the staff in violation of 18 U.S.C. § 1001.³

At sentencing in January 2003, the district court applied the sentencing guideline applicable to fraud and violations of 18 U.S.C. § 1001. The U.S. Attorney had requested a harsher sentencing guideline applicable to violations involving obstruction of justice under 18 U.S.C. § 1505. Section 1505 prohibits anyone from corruptly “endeavor[ing] to influence, obstruct, or impede the due and proper administration of the law under which any pending proceeding is being had before any department or agency of the United States.” In order to apply the requested guideline, the district court determined that it would have to find that the conduct set forth in Kim’s conviction satisfied the requirements of § 1505.

In declining to apply the requested harsher guideline, the district court held that “no ‘proceeding’ [within the meaning of the term in § 1505] was pending at the time of the interview.” Reasoning that Congress “understood there to be a point at which Section 1505 took effect—and by extension, a prior period during which Section

²A recent Commission action against the accounting firm PricewaterhouseCoopers provides another example involving document alteration and destruction prior to the commencement of a formal SEC investigation. In that proceeding, the Commission concluded that it was appropriate to sanction the firm for an audit failure caused by the firm’s audit partner because prior to the commencement of the SEC’s investigation the firm made undocumented changes to its audit working papers and discarded other documents relevant to its audit. Accordingly, the Commission charged the firm with engaging in improper professional conduct in violation of Commission Rule of Practice 102(e).

³This section makes it a felony to knowingly and willfully make a false statement in matters within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States.

1505 did *not* apply,” the court was unable to conclude that the Section . . . plainly and unmistakably proscribe[s]’ false statements made to Federal agents prior to the commencement of formal agency proceedings.” [emphasis in original] [citation omitted]. The court relied on the fact that Kim’s false statement was made prior to the Commission’s authorization of a formal investigation and that no request for formal investigative authority was pending. The court concluded that prior to the authorization of a formal investigation, “the activities of SEC investigators are more in the nature of an ‘informal inquiry.’” With the Commission’s strong support, the Department of Justice has appealed this ruling to the Court of Appeals for the Ninth Circuit, arguing that several appellate courts have held that Federal regulatory agency investigations are “proceedings” for purposes of the Federal obstruction statutes without regard to whether such investigations are preliminary, formally authorized, or conducted only by agency staff. The appeal is pending.

In light of the language of Section 802 of Sarbanes-Oxley, as well as its legislative history, it would appear that under that provision, when an entity or person is aware of even an informal Commission inquiry, the destruction or alteration of documents *prior* to the initiation of a formal Commission investigation, would be a violation of law. Notwithstanding the *Kim* ruling, even prior to enactment of the Sarbanes-Oxley Act, there were circumstances in which the destruction or alteration of documents *before* the commencement of a formal Commission investigation was found to be improper and/or to constitute obstruction of justice.⁴ Under pre-existing law, if entities or persons were aware of a likelihood that the Commission staff would investigate their conduct, it would have been improper for them to destroy relevant records. Such a circumstance could arise, for example, if an entity was aware of an SEC informal inquiry relating to its conduct, if during an informal inquiry the Commission staff instructed the entity or person to preserve relevant records, if an entity voluntarily self-reported violative conduct to the Commission staff, or if professional standards imposed an independent requirement that documents be retained.

Indeed, the Department of Justice’s obstruction of justice case against accounting firm Arthur Andersen, LLP was based on Andersen’s destruction of documents relating to its audits of Enron after the firm learned that the SEC had begun an inquiry into Enron. The document destruction described in the Andersen indictment occurred after the SEC had begun an informal inquiry of Enron, but prior to the commencement of its formal investigation. Nevertheless, Andersen was convicted of obstruction in violation of 18 U.S.C. 1512(b)(2).⁵

⁴Cf., *U.S. v. Cisneros*, 26 F.Supp.2d 24, 39 (D.D.C. 1998) (stating with respect to 18 U.S.C. 1505, which prohibits obstruction of proceedings before departments, agencies, and committees, that “it is established that the statute protects preliminary and informal inquiries against obstruction as well as formal proceedings.”) [citation omitted]; “It is established . . . that the statute protects preliminary and informal inquiries against obstruction as well as formal proceedings.” *United States v. Poindexter*, 725 F.Supp. 13, 22 (D.D.C. 1989) [citations omitted]; “Congress clearly intended to punish obstruction of the administrative process . . . in any proceeding before a governmental agency—at any stage of the proceeding.” *Rice v. United States*, 356 F.2d 709, 712 (8th Cir. 1966).

⁵This statute, which predates Sarbanes-Oxley, provides in relevant part that: Whoever knowingly uses intimidation, threatens, or corruptly persuades another person, or attempts to do so, or engages in misleading conduct toward another person, with intent to cause or induce any person to (A) withhold testimony, or withhold a record, document, or other object, from an official

The Division of Enforcement does not believe that the unavailability of records disposed of prior to the initiation of formal investigations has substantially undermined the Commission's overall enforcement efforts. Nevertheless, the loss of any potentially relevant documents is a serious matter. The best way to address such conduct is through serious sanctions that serve a deterrent function. Accordingly, the Division of Enforcement intends to continue to vigorously enforce existing document preservation and retention rules, and work closely with the criminal authorities when it appears that parties take steps to obstruct SEC investigations by destroying or altering records.

**RESPONSE TO A WRITTEN QUESTION OF SENATOR BAYH
FROM WILLIAM H. DONALDSON**

Q.1. With all of the recent conflict of interest scandals on Wall Street, little has been said about the practice of internalization which involves brokerage firms trading against their own customers' orders because they view them as profitable trading opportunities. We understand that this growing controversial practice in the listed options markets may soon be systematized and taken to a new level if the SEC approves a pending proposal from the Boston Stock Exchange called "BOX." If the SEC is concerned about conflicts and has publicly called for greater study of the adverse effects of internalization, why would the SEC approve any aspects of the proposal that furthers internalization?

A.1. Internalization in the options market is not new. Each of the five options exchanges permits firms to internalize a portion of their customers' orders. The Boston Stock Exchange's proposed new options facility—BOX—would also permit members to internalize customer order flow.

BOX's trading rules were published for comment in January and the comments we received raise a number of concerns. BOX proposed to address many of these concerns in amendments published recently. Commission staff is now analyzing the comment letters received on these amended trading rules. The Commission staff is closely analyzing BOX's trading rules, together with the thoughtful comments received, to determine whether BOX would reduce price competition in the options market by permitting internalization to take place to a greater extent than it does today.

It is very important that the Commission's review of significant new market innovations, such as the BOX, not impede the entrance of new competitors to our marketplace. At the same time, we are obligated to ensure that any proposal will be consistent with the Federal securities laws, including the protection of investors and the public interest.

proceeding; (B) alter, destroy, mutilate, or conceal an object with intent to impair the object's integrity or availability for use in an official proceeding; (C) evade legal process summoning that person to appear as a witness, or to produce a record, document, or other object, in an official proceeding; or (D) be absent from an official proceeding to which such person has been summoned by legal process shall be fined under this title or imprisoned not more than 10 years, or both.

**RESPONSE TO A WRITTEN QUESTION OF SENATOR REED
FROM WILLIAM H. DONALDSON**

Q.1. As you know, e-mail and other electronic records have become critical evidence in SEC investigations of fraudulent or inappropriate behavior by securities firms. Sarbanes-Oxley and other regulations require the preservation of these records when a formal investigation is initiated, but some critical records seem to be lost between the onset of an informal investigation and that of a formal one. What can you attribute this loss to? Are standard practices in the administration of corporate data processing systems to blame? If so, is the SEC considering any steps to mitigate this loss, such as developing guidelines identifying what data must be preserved when an informal investigation is initiated?

A.1. Please see the answer to the preceding question submitted by Senator Evan Bayh.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR SCHUMER
FROM WILLIAM H. DONALDSON**

Q.1. Mr. Donaldson, the SEC has recently come out with some proposals on hedge funds—that they be better regulated, that they register with the Investment Advisors Act of 1940, and that the eligibility requirements for smaller investors be increased.

I do not know whether you would agree with this summary, but it has been pointed out to me that the thinking behind the 1940 Act was, in short, that if you were marketing to smaller, less “sophisticated” investors you needed to register. And if you were marketing to wealthy, “sophisticated” investors it was expected that the investor had the wherewithal and experience to judge the risk himself, so no registration and looser standards.

By that logic, the SEC’s proposal could be seen to contradict the thinking behind the 1940 Act.

Finally, I would like to get your views on whether, if hedge funds are performing well and attracting some of the best investment talent, how can we increase the average person’s ability to invest with them. Currently we are raising the threshold, but if the performance is there, perhaps we can also consider ways to enable average investors to benefit from hedge fund performance.

A.1. Two questions are posed. First, you inquire as to whether the recommendations that the staff made in its September 29, 2003 report to the Commission, *Implications of the Growth of Hedge Funds*,¹ contradict the rationale behind the regulatory framework of the Investment Company Act of 1940 (Investment Company Act). Second, you seek my views on whether the Commission should consider making hedge fund investments available to a wider universe of investors.

Hedge funds generally avoid regulation under the Investment Company Act by relying on one of two exclusions from the definition of an investment company set forth in that statute. Section 3(c)(1) of the Investment Company Act excludes from the definition of an investment company any issuer whose outstanding securities are beneficially owned by not more than 100 persons and which

¹Implications of the Growth of Hedge Funds (September 2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf> (Hedge Fund Report).

does not presently propose to make a public offering of its securities (Section 3(c)(1) hedge fund). Section 3(c)(1) reflects Congress's view that investors in small, privately placed investment companies are able to access the type of information necessary to protect their own interests.²

Section 3(c)(7) of the Investment Company Act excludes from the definition of an investment company any issuer that does not propose to make a public offering and whose securities are owned exclusively by "qualified purchasers." Qualified purchasers are generally individuals with \$5 million in investments and others who own or invest at least \$25 million in investments. Section 3(c)(7) reflects Congress's view that certain highly sophisticated investors do not need the protections of the Investment Company Act because those investors are in a position to appreciate the risks associated with pooled investment vehicles.³

The staff's Hedge Fund Report makes no recommendations with respect to Section 3(c)(1) or 3(c)(7), nor does it recommend any regulatory action under the Investment Company Act that would affect who may invest in hedge funds. In fact, the staff's report essentially recommends maintaining the current regulatory approach that investors in hedge funds that are generally smaller or are owned by highly sophisticated investors do not require the protections of the Investment Company Act.

Under the staff's primary recommendation, hedge fund advisers would be required to register with the Commission under the Investment Advisers Act of 1940 (Advisers Act). Unlike the Investment Company Act, which imposes a comprehensive regulatory regime on investment companies, the Advisers Act is a disclosure-oriented regulatory scheme that requires investment advisers to disclose certain information, including, for example, information about their organizational structure, assets under management, nature of the services they provide, and how they address certain conflicts of interest. The Advisers Act does not regulate the sophistication of an investment adviser's clients.⁴

You also seek my views on whether the Commission should increase the availability of hedge funds for less sophisticated investors. In the Hedge Fund Report, the staff identified some of the differences between hedge funds and registered investment companies and expressed its view that such hedge funds have characteristics

² Although Section 3(c)(1) does not specifically require any level of financial sophistication for an investor to be eligible to invest in a Section 3(c)(1) hedge fund, many such hedge funds rely on a safe harbor provided under the Securities Act of 1933 (Securities Act) to offer and sell their securities. See Regulation D under the Securities Act. Under Regulation D, hedge funds may offer and sell their securities to accredited investors and no more than 35 nonaccredited investors. In general, accredited investors are individuals who have a net worth above \$1,000,000, or who have income above \$200,000 in the last 2 years (or \$300,000 with spouse) and have a reasonable expectation of reaching the same income level in the year of investment.

³ Section 3(c)(7) was added to the Investment Company Act in 1997. See S. Rep. No. 293, 104th Cong., 2d Sess. 10 (1996).

⁴ The Advisers Act differentiates among advisory clients based on the types of fees that they are charged by prohibiting registered investment advisers from charging performance-based fees (for example, fees based on a percentage of the fund's capital gains and capital appreciation) to their less wealthy clients. Most hedge funds charge these types of fees. Under rules adopted by the Commission under Section 205 of the Advisers Act, an investor must have \$750,000 invested with the investment adviser or generally have a net worth of \$1.5 million to be eligible to invest in a Section 3(c)(1) hedge fund that pays a performance fee. If the Commission were to require the registration of hedge fund advisers under the Advisers Act, this rule would have the effect of raising the minimum net-worth or investment required for investment in Section 3(c)(1) hedge funds that pay performance-based fees to their advisers.

that may provide certain benefits, including increased diversification, to less sophisticated investors. The staff concluded that while it did not believe that these investors should invest directly in hedge funds, it was worth inquiring into whether there may be benefits of having registered investment companies engage in the types of strategies that are currently being utilized by hedge funds. The staff recommended that the Commission consider issuing a concept release with a view toward determining whether hedge fund strategies may be effectively deployed in registered investment companies and what types of relief might be necessary under the Federal securities laws to effectuate this goal.

As you know, the Commission has the staff's recommendations under consideration, but has not yet made any decisions as to which recommendations it may direct the staff to proceed upon. We look forward to taking up these recommendations for consideration in the near future.

Q.2. Mr. Donaldson, information drives the health of our securities markets, and I want to ask you about one of the most critical pieces of information—how much money a company actually earns.

A recent article (Sunday, September 21, 2003) in *The New York Times* on the many different ways to measure a company's earnings is titled, "Counting the Ways to Count Earnings." Perhaps the title says it all.

Last time you testified I asked you about yet another differential—the differences between book and tax income—and I appreciated your willingness to consider that issue.

What can or should the SEC do to clear through this confusion on earnings?

In your view, do we have a risk to the long-term health of the securities markets if the most critical number driving those markets—earnings—is such a source of debate and varying standards?

A.2. The newspaper article cited in your question refers to three measures of corporate earnings based on a particular company's financial results. These are operating earnings, reported earnings, and core earnings. The article defines reported earnings to be earnings calculated using generally accepted accounting principles (GAAP). Operating and core earnings, as referred to in the article, add or remove items from reported earnings.

Because companies may manipulate such "pro forma" earnings to create a desired result, Congress, in Section 401(b) of the Sarbanes-Oxley Act of 2002 (Act), directed the Commission to write rules that would require disclosures of "pro forma" earnings to be presented in a manner that (1) does not contain an untrue statement of a material fact, or omit to state a material fact necessary to make the "pro forma" financial information, in light of the circumstances under which it is present, not misleading, and (2) reconciles the disclosure with the financial condition and results of operations of the issuer prepared in accordance with GAAP. On January 22, 2003, the Commission announced, in Securities Act Release No. 8176, adoption of the rules required by section 401(b).

These new rules take a three-part approach to the disclosure of "pro forma," or "non-GAAP" information. Consistent with Section 401(b) of the Act, these rules impose requirements on the disclo-

sure of non-GAAP information, rather than prohibiting that disclosure.

- The first part of this approach—new Regulation G—imposes the requirements of Section 401(b) of the Act on any public disclosure or release of material information (regardless of whether that disclosure or release is filed with the Commission) that contains non-GAAP financial measures. The measures discussed in the cited article—“operating earnings” and “core earnings” are examples of non-GAAP financial measures.
- The second part of the approach imposes additional requirements regarding the inclusion of non-GAAP financial measures in filings with the Commission. Among other things, these additional requirements obligate companies to disclose clearly how management uses each disclosed non-GAAP financial measure and why that measure is useful to investors.
- The third part of the approach requires companies to furnish their earnings releases to the Commission on Form 8-K and, in addition to complying with Regulation G, disclose clearly how management uses each non-GAAP financial measure included in the earnings release and why that measure is useful to investors.

Q.3. In the development of the Sarbanes-Oxley Act, there was considerable debate regarding the appropriateness of funding accounting standard-setters through voluntary private sector contributions. The Act creates a system of levies on publicly traded companies for the Financial Accounting Standards Board (FASB). Currently, the FASB’s international counterpart and partner, the International Accounting Standards Board (IASB), is funded largely through voluntary contributions. Do you have any thoughts regarding whether the FASB approach is appropriate for the IASB?

A.3. The Trustees for the International Accounting Standards Committee (IASC) Foundation, which currently raises funds for the IASB, are reviewing alternatives for the future funding of the IASB, including alternatives that could reduce reliance on voluntary contributions. While approaches such as the Sarbanes-Oxley Act provisions for funding for the Financial Accounting Standards Board through “support fees” assessed on issuers of securities might be considered, significant differences exist between the IASB and FASB and the IASB situation is more complex. One important difference is that the goal of the IASB is to set global accounting standards. The standards it sets are or will be the mandated accounting standards for the European Union countries beginning in 2005 and for a number of other countries that have decided to adopt international accounting standards. It is possible that some of these countries might have competitive interests in the outcome of a specific IASB project. Care would have to be taken, therefore, to assure that those countries with companies or other sources (for example, nonvoluntary sources, if such approaches are adopted) providing the most funding for the IASB would not seek added influence with the IASB.

In any event, we believe that the IASC Foundation Trustees should be allowed to complete their review and, after appropriate consideration of all the issues, present their conclusions and recommendations for public consideration.

Q.4. Your testimony states that the global settlement is still being reviewed by the U.S. District Court. Does the SEC intend to further revise its rules affecting stock analysts to impose additional safeguards to all securities firms?

A.4. The court gave final approval of the global settlement on October 31, 2003.

The Commission is currently determining whether regulatory gaps still remain in the area of analyst research, and is considering what, if any, additional analyst rules are appropriate for the entire industry, including whether there are additional elements of the settlement that should be incorporated into industry-wide rules.